Practical strategies to limit preference liability

April 24, 2020

Anticipating a surge of bankruptcy filings resulting from COVID-19, it is important for businesses to understand the basic elements of a bankruptcy preference and the defenses available to defeat them. This article provides a summary of those elements, available defenses and presents practical strategies that can mitigate and in some cases avoid preference liability.

Elements of a preference claim

Section 547 of the Bankruptcy Code sets forth the required elements that a trustee or debtor in possession must successfully establish to recover a preferential payment. The six elements of a preference ensure that the trustee bears the burden of proof in establishing that the payment was:

1. **A transfer of property of the debtor.** It is important to remember that any transfer of an interest of the debtor in property can be avoided. While preference actions typically focus on payments, a trustee can also avoid the granting of a mortgage, security interest or other lien.

2. **Made to or for the benefit of a creditor.** The definition of creditor is very expansive and includes any entity with any type of pre-petition claim against the debtor. However, certain circumstances might exist in which the debtor makes payment on another party's debt. As a result, the party receiving the payment would not actually be a creditor of the debtor.

3. **For or on account of an antecedent debt owed by the debtor before the transfer was made.** If the debt arose after the payment was received, the payment would not be considered a preferential transfer.

4. **Made while the debtor is insolvent.** Courts presume the debtor is insolvent in the 90 days preceding a bankruptcy petition, unless the creditor can present evidence to the contrary.

5. **Made within 90 days before the date of filing the bankruptcy petition (or within one year if the creditor is an insider of the debtor).** For payments that are made by check, the date of the transfer is the date on which the check clears.

6. **Resulted in the creditor receiving a greater distribution than it otherwise would have in a Chapter 7 distribution.** This "liquidation test" requires an evaluation of whether the transfer is preferential, (*i.e.* whether the creditor received special benefit from the transfer). To apply the liquidation test, a creditor must hypothesize the values that would have been realized in a Chapter 7 liquidation.

Affirmative defenses

Even if the trustee can establish the elements of a preferential transfer, the Bankruptcy Code provides a variety of affirmative defenses that can be raised to prevent the avoidance of the payment. Three primary defenses include:

1. **Ordinary course of business.** Although the ordinary course of business defense is the most difficult and fact-intensive affirmative defense to prove, it also has the broadest application. A creditor can prove that the payment was received either:

    a. *In the ordinary course of business between the parties (subjective prong).* The creditor must establish that the debt was typical of those arising between the parties. An analysis of the parties' course of dealing is required to determine the typical debts incurred by the debtor and the typical payment terms acceptable over the course of the parties' relationship.

    b. *On terms ordinary for their particular industry (objective prong)*. The creditor can demonstrate that the payment was made within the ordinary terms used in the parties' industry. Note, however, that if the issue ends up in trial, the creditor will need to present evidence to demonstrate the credit terms typical in the parties' industry.

2. **Contemporaneous exchange.** This defense allows a creditor to defeat a preference claim if the payment was made contemporaneously with delivery or as "cash on delivery" (COD). If the parties had a mutual understanding that the goods or services were provided on COD, the payments are not recoverable by the trustee. Because the trustee may not have access to the invoices or shipping records at the time the complaint is filed or demand is made, the creditors should compile this information immediately to properly analyze the available defenses. If the creditor can supply the trustee with information to support a contemporaneous exchange, the creditor will have a decided advantage in settling or obtaining a dismissal.

3. **Subsequent new value.** The defense of subsequent new value allows any creditor that ships additional inventory or otherwise extends additional credit to the debtor after receiving a preferential transfer to credit the amount of the new value against any alleged preferential transfer. If a creditor can establish that it extended new value to the debtor after the alleged preferential transfer was received, the creditor is entitled to offset the amount of the new value from the amount recoverable.

Strategies for limiting exposure:

With a basic understanding of the elements and defenses to a preference action, businesses can establish practices and procedures to minimize their risk of preference exposure, including:

- **Establishing a course of conduct.** Creditors should work to establish open lines of communication with customers regarding payment of invoices. If and when payments are not made timely, firm and regular demand for payment should be made consistently. Creditors benefit from establishing consistent payment histories and standard default-notice procedures.

- **COD or cash-in-advance.** To the extent a customer falls behind, creditors should not be timid about discussing COD terms as a required term for future deliveries, if timely payment is not made. Taking these steps early in a relationship will establish them as part of the parties' regular course of dealing. As the ultimate protection against mounting preference exposure, creditors should consider requiring payment in advance of delivery. This pre-payment structure will insulate creditors from preference liability, because they will not be receiving payment "on account of an antecedent debt."

Conclusion

As with many best practices, these strategies involve both legal and business concerns. Therefore, it is important to consider the business implications of the various proposals in light of the legal risks. If you find yourself the target of a preference demand, immediately begin gathering information related to the transfers at issue and consult legal counsel. Armed with this information, your team can properly evaluate the available defenses and make an informed business judgment on how best to defend your particular case.

Authors

Justin Ristau

Partner & Creditors' Rights/Bankruptcy Chair

Columbus
614.227.4857
jristau@bricker.com