



Preferences in Bankruptcy Cases, or Do I Really Have to Give the Money Back?

A bankruptcy trustee has demanded that your client return certain payments made by a debtor now in bankruptcy. Your client had provided goods or services in what would ordinarily be regarded as a standard business transaction. Referred to as “preferences,”¹ such claims are troublesome to creditors, particularly because a good-faith and innocent recipient, the creditor, may have to refund payments it received from a bankrupt debtor before the bankruptcy filing. Understanding basic preference law should aid you in conversations with, and defense of, your creditor client.

The Basics

Preference law under the Bankruptcy Code is strict. A trustee must prove six elements to recover under § 547(b): (1) any transfer of an interest of the debtor in property; (2) to or for the benefit of a creditor; (3) for or on account of an antecedent debt; (4) made while the debtor was insolvent; (5) made on or within 90 days before the date of the filing of the bankruptcy petition; and (6) that enabled the creditor to receive more than it would otherwise have received if the transfer had not been made and the case had proceeded under Chapter 7 of the Bankruptcy Code (liquidation).² A preferential transfer may include money, property, or lien rights.

Some Common Creditor Defenses

Thankfully, for the creditor in the goods and services situation, some defenses exist. If the trustee is able to prove all the preference elements, the Bankruptcy Code provides three primary defenses under § 547(c): (1) the contemporaneous exchange; (2) the ordinary course of business; and (3) the subsequent new value defenses.³

Contemporaneous Exchange

The “contemporaneous exchange” defense protects from avoidance the simultaneous payment by the debtor for goods or services provided at the same time. A “cash on delivery” transaction, where

the payment is received about the same time goods are delivered, is the perfect example. The debtor and creditor must also intend for it to be contemporaneous. This defense may also apply if the terms were for short-term credit, such as a 30-day repayment arrangement where the debtor fully pays within 30 days. The policy behind this defense is to give the troubled debtor access to goods and services without causing creditors to worry that they will lose payments received.⁴

Ordinary Course of Business

The “ordinary course of business” defense may protect creditors who received payments that are either consistent with the historical business relationship or in conformity with the typical industry standard. To prove this defense, the creditor must demonstrate that the payments made were in the ordinary course of business between the debtor and creditor *or* that they were consistent with transactions in the same or similar industries.⁵ Courts consider, among other factors, the length of time of the business relationship, whether the payment at issue conformed to past payment practices, and if the creditor engaged in unusual collection activities.⁶ Although there is no precise legal test to determine if preference payments were made in the ordinary course of business,⁷ this defense is often met if the preferential payments fall within the typical range of payments from the date of the invoice date *or* according to payments consistent with industry standards.

Subsequent New Value

The “subsequent new value” defense will at least reduce the creditor’s potential preference liability by the amount of goods or services provided to the debtor *after* the preferential transfer. The statute provides the defense to “the extent” that the transferee gives “new value to or for the benefit of the debtor.”⁸ Thus, if the debtor made a payment to a creditor that meets the elements of a preference, and the creditor subsequently provided additional goods or services, the creditor can reduce the overall preference liability by the amount of those additional goods or services pro-

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vided.⁹ This defense also encourages creditors to continue doing business with the debtor prior to bankruptcy without concern over subsequently losing those payments.

Check the Filing Deadline

Another defense to keep in mind is the statute of limitations for preference claims. Under § 546(a) of the Bankruptcy Code, the trustee must bring an adversary proceeding within two years from the bankruptcy petition or one year after being appointed the trustee, whichever is later. Otherwise, assuming no extension is granted, the preference claim is barred.

receive more than it would have in a Chapter 7 case. Keep the deposit intact and apply the payment to the outstanding receivable.

3. *Demand Cash on Delivery:* Cash on delivery turns a credit transaction into a substantially contemporaneous exchange so long as the debtor pays at the time the creditor provides the goods or services or shortly thereafter.
4. *Use Broad Contract Terms:* Use broad contract terms that permit different types of payment so that any continued payment by the debtor before bankruptcy will be considered in the ordinary course of business. For example, the contract should read along the lines of “the debtor making payment,” rather



Practical Advice

When bankruptcy seems imminent, questions may arise for a creditor worried about potential preferences. Our advice includes the following:

1. *Take the Money:* A creditor should always accept payment, even when concerned that the payment is a potential preference. Preferential transfers are only voidable under the Bankruptcy Code; they are not per se void. To be voidable, all six § 547 requirements must be met, which can be difficult. Even if the requirements are satisfied, the penalty to the creditor is simply to return the money received.
2. *Consider a Deposit:* A deposit permits a creditor receiving payment to claim that it was partially secured, perhaps defeating any argument that the payment allowed the creditor to

than “the debtor will pay in cash.”

5. *Don't Change Things Near the Time of Bankruptcy:* The debtor's payment method should not be changed near the time of bankruptcy, in order to avoid the argument that a payment was made outside the normal course of business. Also, the mode of payment should be consistent with past forms of payment.
6. *Consider Settling:* If the trustee makes a demand for return of the alleged preferential payments, it is often cheaper to respond with defenses and offer a smaller settlement amount instead of threatening to go to court. The trustee may have many potential preference claims against other creditors, making receipt of a reasonable settlement offer tempting in order to avoid the risk of litigation.

Summary

Preference cases are relatively straightforward. The foregoing should provide you and your client with the basic information regarding preferential payments and, with just a little precaution, a defense or two. ☉

Endnotes

¹It is said that the bankrupt debtor prefers one creditor over another since there are insufficient funds to pay all creditors.

²11 U.S.C. § 547(b).

³*Id.* § 547(c)(1).

⁴*See Jones Truck Lines, Inc. v. Central States SE & SW Areas Pension Funds (In re Jones Truck Lines, Inc.)*, 130 F.3d 323, 326 (8th Cir. 1997).

⁵11 U.S.C. § 547(c)(2).

⁶*Payne v. Clarendon Nat'l Ins. Co. (In re Sunset Sales, Inc.)*, 220 B.R. 1005 (B.A.P. 10th Cir. 1998).

⁷*Gasmark Ltd. Liquidating Trust v. Louis Dreyfus Natural Gas Corp.*, 158 F.3d 312, 317 (5th Cir. 1998).

⁸11 U.S.C. § 547(c)(4).

⁹*New York City Shoes, Inc. v. Bentley Int'l Inc.*, 880 F.2d 679 (3d Cir. 1989).

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in restructuring debt. The Supreme Court determined earlier this year that a Chapter 11 debtor cannot sell property free and clear of liens without allowing a secured lender to credit bid its debt against competing bids to purchase the property.⁵ Further, individuals have resorted to filing Chapter 11, but because of the amount of debt may have difficulty in getting a plan confirmed because some courts believe that the absolute priority rule applies to individual Chapter 11 debtors.⁶ As such, if there is any area in bankruptcy that has received much attention, it is in the context of Chapter 9 for municipalities. State legislatures and Congress have debated the impact of municipalities resorting to bankruptcy relief. Viewed as a panacea by some, many city leaders are considering filing for bankruptcy as a way to alleviate debt and coerce city unions into modifying collective bargaining agreements with public unions. Such an approach might avoid the prospect of city councils making budget cuts that would reduce city services and restrict city employee pay and benefits. Although it is questionable whether municipalities can alter union contracts, the mere threat of filing Chapter 9 pits city officials and taxpayers against city employees. Although Chapter 9 has been in existence since the 1938 depression, it has not been utilized often.

The reasons for filing Chapter 9 and the limitations thereto dictate how Chapter 9 may be utilized. For example, the debtor must be a municipality. The state in which the municipality is located must authorize under state law that it may do so (roughly half of the states allow municipalities to file for Chapter 9). The municipality must be insolvent and desire to effect a plan or debt adjustment with no prospect of liquidation. The filing must be the last option

available. As a result, while Chapter 9 may be viewed as a substitute or alternative for budget cutting, it requires a great deal of negotiation and agreement. While municipal filings appear to be the next frontier in bankruptcy, it is difficult to assess how viable the filings will be. Until then, bankruptcy will remain relatively unchanged and will operate as it has for the past 33 years.

While bankruptcy practice may not change much in the upcoming years, bankruptcy courts will have to conduct operations with reduced staff and funding. The challenge will be to provide exemplary service in the wake of budget reductions. This will require a re-emphasis on technology and shared services. It is in the environment of “more with less” that the courts must be innovative. ☉

Endnotes

¹501 U.S. 78 (1991).

²11 U.S.C. § 1328(f)(1).

³___ F.3d ___, 2012 WL 3797696 (10th Cir. 2012) (court denied debtors' request to strip off second lien on their home because they failed to make an argument under § 1322(b)(2) that would have allowed the court to consider strip-off of second lien).

⁴2012 WL 1649853 (11th Cir. May 11, 2012) (Chapter 7 debtor could strip off wholly unsecured lien).

⁵*See RadLAX Gateway Hotel v. Amalgamated Bank*, 566 U.S. ___, 132 S. Ct. 2065 (2012).

⁶*See In re Maharaj*, 681 F.3d 558 (4th Cir. 2012) (absolute priority rule does apply to individual Chapter 11 debtors); *see also In re Friedman*, 466 B.R. 471 (B.A.P. 9th Cir. 2012) (absolute priority rule does not apply in individual Chapter 11 cases).

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