9 Ways to Defend A Preference Action Without Really Trying — And One More

Find out how to respond when a trustee embarks on a collection effort.

By Steven F. Werth

Litigation actions based on Section 547 of the Bankruptcy Code, typically called "preference actions," are one of the most annoying and counterintuitive powers that a bankruptcy trustee or debtor-in-possession[1] possesses.

In order to bring a preference action against a company, that company must have performed some service or delivered some good to a debtor pre-bankruptcy. Additionally, the company either had to be paid by the debtor or receive a lien on the property of the debtor within 90 days of commencement of the bankruptcy case.

So long as the debtor was insolvent at the time of payment (a fact which is commonly met) and the payment is more than the company would have received if the debtor had filed for Chapter 7 liquidation (another often-met factor), companies can expect the trustee to make some form of collection effort. Here are 10 easy ways to respond.

The following bio and photo were inadvertently not included in the "9 Ways To Defend A Preference Action Without Really Trying — And One More" article included in the Nov./Dec. issue of Commercial Law World. The CLW staff regrets the error and apologizes for its omission: Steve Werth is a bankruptcy attorney with the firm of SulmeyerKupetz in Los Angeles, California. He has represented creditors, debtors and trustees in a wide range of complex Chapter 11 bankruptcy cases.

1. If a trustee mails a letter, ignore it.

Prior to actually filing a complaint against a company to initiate litigation, a trustee may send a letter threatening to do so. There are two good reasons to ignore it, and two good reasons to respond to it.

The first reason to ignore is that trustees occasionally send letters out to companies they may not ultimately file a complaint against. In a large Chapter 11 bankruptcy case, trustees may ultimately decide to file complaints only against companies receiving total payments above a certain threshold. As a company receiving such a letter, you may fall under that threshold without knowing it.

The second reason to ignore the letter is that responding with an articulation of defenses likely will not result in the trustee agreeing to not pursue the action. One exception to this rule is if the company is a public company, in which case it must disclose threats of litigation and may want to address the trustee's letter sooner rather than later.

The other exception is when the company possesses unusual defenses that the trustee may not know about. In that situation, it may make sense to respond to a trustee's letter in the hope of saving attorneys' fees in the long run. What defenses are worth raising in an initial letter? See below.

2. If the total payments are small, the trustee loses.

The Bankruptcy Code states a trustee cannot bring a preference action unless at least $5,850 was paid to the company in the 90 day period.[2] Additionally, 28 U.S.C. §1409(b) states that if the total amount sought is less than $11,725 (or $17,575 against an "insider"), the trustee has to file the complaint in the company's home district—something few trustees are likely to do unless the company's home district is the same as the debtor's.

Thus, if the amounts in question are small, the trustee either may not proceed with the action, or will incur substantial costs to do so.

3. If the payments were received for goods or services to be provided in the future, the trustee loses.

It may be fraud, but it is not a preference for a debtor to pay a company when it has no obligation to do so.[3] Debtors may do this because it is the industry standard (i.e, industries which require advance payment before services are rendered), or simply because the company requested it (and a company should request advance payment or COD terms, if it believes a debtor may file for bankruptcy protection).

Landlords or insurance providers may require payments to be made up front every month or every year. Certain service providers may require up-front deposits before the provider is obligated to even begin work on a project. If a company can make the argument that it received payments first and provided goods or services later, it should do so as soon as possible.

4. If the company has unique defenses, the trustee loses.

There are several defenses that are not immediately obvious from a review of Section 547 that may stop a preference action in its tracks. One of the most significant is if the company had an executory contract or lease with the debtor, which was assumed by the debtor post-petition.

A landlord, for example, might lease property to a debtor, and during the bankruptcy case, the debtor assumed the lease pursuant to Section 365—meaning it agreed to continue under the terms of the lease and pay all pre-petition amounts owed to the landlord.

If so, the trustee cannot avoid any potentially preferential payments made to the landlord, as the trustee already agreed, in a sense, that the debtor must pay those pre-petition amounts.

The same scenario may apply to insurance carriers or even critical vendors who are the beneficiaries of a critical vendor motion. Other defenses include that the company would have possessed a lien in a Chapter 7 case if the payments had not been made (thus bolstering the argument that in a liquidation, the company would have been paid in full, and thus the trustee cannot meet one of the initial Section 547 requirements), that the company is a secured creditor for some other reason, or that the debtor and the company reached agreement in the bankruptcy case to waive all claims against the company.

5. Ask about a claim waiver.

Many companies that do business with a debtor pre-bankruptcy are still owed money by the time the debtor commences a bankruptcy case, which means that the company possesses a claim against the estate.

[2] Section 547(a)(9). Further Section references are to Title 11 of the United States Code (the Bankruptcy Code).

[3] A discussion of fraudulent conveyance actions is outside the scope of this article, however it should be noted that a trustee may assert that a transfer was either a preference under Section 547 or a fraudulent conveyance under Section 548, so any response to a trustee who is asserting both causes of action should address the merits of each action separately.

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The potential payout on such claims varies from case to case, but provided that the payout is expected to be more than zero, the trustee has an interest in getting a company to agree to waive its claim. If the likely payout is significant, it may be that a trustee is willing to accept some portion of a claim waiver in complete satisfaction of a preference action.

Trustees typically will want additional dollars to be paid into the estate above and beyond a mere claim waiver, so this issue is one that companies often must raise on their own initiative, rather than waiting for the trustee to propose it.

Ask about potential payouts in the case. Then, if it makes sense after consideration of the size of the claim and the likely percentage payout based on the claim, a company might want to ask whether a trustee is willing to accept a claim waiver to resolve a matter.

6. If the trustee files the complaint, make one argument first.

Of all the defenses that exist to a preference action, few are more persuasive than the assertion that a company provided new value to a debtor after receiving a potentially avoidable transfer.

The arithmetic is not as simple as totaling up the value of all goods or services delivered during the 90-day preference period, and subtracting that from the total amount of claims asserted by the trustee — but it is not difficult.

Further, because the trustee will realize that the defense is a complete one, to the extent it exists, the trustee will have an interest in fully understanding a company's new value defense, as well.

First, calculate the date each payment was received by the company in the 90-day period. If a payment is by check, and the receipt date is within 30 days of the date of check clearance, the date of receipt is the date the check arrived in the mail. If the check was deposited later, the date of receipt is the date of deposit.[4]

Once those dates are identified, determine if, after any of those dates, the company provided goods or services to the debtor. If so, determine which date those goods or services were provided, and then use their value to eliminate past liability on a dollar-for-dollar basis.

Application of this defense may knock exposure down to a mere fraction of what is sought in a complaint. Send your analysis by e-mail or letter to the trustee. Is the trustee accepting claim waivers yet? Now, maybe so.

7. Make every other argument next, except for your best one.

In between an assertion of a new value defense and the argument that is most likely to apply (given its own separate number below), check if any of the following defenses could apply and, if so, bring them to the trustee's attention ahead of everything else:

- **The company delivered goods or services contemporaneously with payment from the debtor.** Did the company deliver products or services immediately upon payment for that product? Was that give-and-take exchange intended to occur simultaneously? Were the payments COD? If so, Section 547(c)(1) is the defense that applies. Don't quote it; just explain the facts, which should convince a trustee to drop the matter.
- **The company received payment, but simply handed the payment over to a third party.** In that case, the trustee may be entitled to sue the third party as a subsequent transferee — but should be convinced pretty quickly that the company was not the true initial transferee of the transfer and recovery lies elsewhere. This is called dominion test in the Ninth Circuit and the dominion and control test in most other circuits.
- **The debtor made the payment to the company out of a trust account** — which would suggest the debtor never had a possessory interest in the funds.
- **The debtor made the payment to the company as an agent of a third party that owed the company.** If so, the debtor again may not have had an interest in the funds.

8. Ordinary course of business: not fast, but powerful.

There is one defense that a company should always assert in a preference action, and that is that the payments were made in the ordinary course of business. Section 547(c)(2) is the statutory basis for the defense, and it states that the trustee may not avoid transfers that were made in the ordinary course of business between the parties or were ordinary for the industry.

A company, to successfully assert this defense, need only meet one of those requirements. Even companies that have never done business with a debtor are entitled to assert this defense.

Because it is 100 percent likely that every company sued by a trustee in a preference action will assert this defense, contacting a trustee initially about the strength of one's ordinary course of business defense is not likely to result in a

[4] Section 547(e)(2) protects diligent recipients of payments from debtors by giving them a few extra days of time when new value can apply. This reflects the business reality that companies delay providing goods while they wait for checks on past-provided goods to clear.

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rapid dismissal of the preference action.

Further, it is not easy to obtain a dismissal of a case on ordinary course of business grounds by providing extensive information to a trustee. A trustee is just as likely to purport to find discrepancies in the payment history of the party and assert that the ordinary course of business defense does not apply.

Thus, this aspect of a preference action is often the most difficult to discuss with the trustee. However, there are certain things that can be done, with relative ease, to deal with this problem.

First, the company should pull its records relating to the debtor's payment history and check to determine if the debtor appeared to be paying invoices later than normal the preference period, compared to before then.

If the difference is stark — for instance, if a debtor normally paid invoices 30 to 45 days after invoice but in the preference period paid invoices 60 to 75 days after invoice, that could be evidence a trustee uses to assert that the payments were not ordinary.

If the pattern of payments falls within a normal range that existed prior to the petition date, consider sending that information to the trustee. The best format to do so is a spreadsheet showing invoice date, payment date, payment amount, and number of days between invoice date and payment date.

Also consider sending the backup information to the trustee so the trustee can confirm the information on the chart. The trustee will be entitled to this information in discovery, so there is no reason to not deliver it, to the extent that it is strong.

Should certain payments in the preference period stand out as being potentially late-paid, check to determine if those are payments that are protected by subsequent new value delivered by the company. For instance, if a company receives $10,000 from a Debtor 80 days prior to the bankruptcy case, and the company then delivers $15,000 worth of goods to the debtor 75 days prior to the bankruptcy case, that $10,000 payment to the company is completely protected by the new value defense, regardless of whether the payment was ordinary or not.

If certain anomalies still remain, it may not be possible early in a case to convince a trustee that all payments are fully protected by defenses. In that case, the last defense strategy will not involve much if any attorney involvement is to attempt to settle.

9. Settlement

Settlement was discussed briefly above in connection with claim waivers. If claim waivers are not adequate to resolve a case quickly, a company may have no choice, should a complaint be filed, than to hire an attorney or attempt to settle with a trustee.

Trustees will often evaluate the magnitude of a case by taking into account all defenses other than the ordinary course of business defense, so a company may have a good idea as to how big a trustee sees the case by determining the effectiveness of their other defenses.

A case in which the trustee asserts $100,000 in transfers but the defendant possesses a new value defense of $90,000 will look unappealing compared to a case to recover only $40,000, but the only defense asserted is the ordinary course of business defense. The negotiation of settlement likely will be seen, in the trustee's eyes, as a percentage of the amount after only the ordinary course portion remains.

The trustee will seek a higher percentage of that amount if the trustee perceives the case to be a weak ordinary course defense case but may settle for a lower percentage amount if the case is identified as a strong ordinary course defense case.

10. Depose the accounts payable people.

In a case where persons who worked in the debtor's accounts payable department are still either employed or working for the trustee in some other capacity, try to obtain their contact information.

The trustee has to disclose their identity eventually, and the trustee's hesitation at identifying persons who may have overseen payments in the preference period may indicate that the trustee recognizes that these individuals might state, if deposed, that the debtor was trying its hardest to pay all of its bills—not preferring to pay one creditor over another, at all.

This last topic may not truly belong on this list, as depositions are expensive and hardly qualify as not really trying to defend a litigation action — but attempting to schedule such a deposition may quickly resolve a large case, without having to expend too much further in legal fees.

Conclusion

There are plenty of ways in which a company can spend significant time and resources in defending a preference action, yet much of the significant work of eliminating or at least reducing exposure on a preference action can take place before a company hires an attorney. ●