DIVERSITY NEWS *BY JENNIFER HOOVER*

AN OUNCE OF PREVENTION IS WORTH A POUND OF CURE

A PREFERENCE PRIMER: WHAT YOU NEED TO KNOW TO PROTECT YOUR BUSINESS

BANKRUPTCY IS A PART OF THE EVERYDAY VERNACULAR FOR COMPANIES ACROSS THE UNITED STATES. Although bankruptcies have slowly trended downward over the past few years, they remain a viable restructuring option for many distressed companies. Even if your company has escaped the distressed financial situation that may lead to a bankruptcy filing, your company has undoubtedly been affected by the bankruptcy filing of another. For suppliers of a bankrupt debtor, who often have had long and loyal relationships with the debtor, bankruptcies surely upset the traditional relationships that a supplier and the bankrupt debtor had prior to the bankruptcy filing. Typically, the supplier is left with a large receivable that likely will remain unpaid (or will be paid back at a fraction of what was owed) and faced with the risk of throwing additional good money after bad by continuing its relationship with the debtor. It is often the case that these same suppliers, who supported the debtor through its bankruptcy case, will find themselves a defendant in what is commonly called a "preference action"—a suit brought under Section 547 of the Bankruptcy Code[1]—leaving the supplier to ponder how it could be left "high and dry" on its pre-petition claim against the debtor and still be subject to a lawsuit for payments received within 90 days of the petition date.[2] Preference actions are frustrating, inconvenient, and can be, based upon the amounts involved, detrimental to your own company. This article serves as a refresher on the purpose of preference actions, the elements of a *prima facie* preference action, and the various defenses that your company may have to a preference action. While not all companies are alike, and you should contact a bankruptcy professional to discuss this further, this article will briefly discuss some strategies to protect yourself against future preference actions with your existing business relationships.

There are two goals of the United States Bankruptcy Code. The first is to provide a debtor with a "fresh start." The second is to ensure that similarly situated creditors are treated fairly and equally in a transparent process. Preference actions are tied to the second of these goals. The 90-day period prior to a bankruptcy is deemed by the Bankruptcy Code to be a *per se* insolvent time for the debtor. The Bankruptcy Code creates a bright line rule allowing a debtor to recover from its creditors payments it made to those creditors in the 90-day period, assuming they meet all the elements of the cause of action.[3] The purpose of these actions is to recover all the monies that were paid out to creditors that took advantage of the debtor's slide into bankruptcy and received payments that were non-ordinary in order to maximize their personal recoveries and to distribute those funds fairly and equally among all similarly situated creditors.

Generally, the debtor (or trustee) needs to prove the following in its case in chief:

- The payment must be to or for the benefit of a creditor and made on account of an antecedent debt owed by the debtor before such transfer was made;
- The payment must be made when the debtor was insolvent;
- The payment must be made on or within 90 days before the date of the bankruptcy filing for most creditors; and
- The payment must enable the creditor to receive more than it would have received if the case were a bankruptcy case under Chapter 7 of the Bankruptcy Code (a liquidation), the transfer had not been made, and such creditor received payment to the extent of Chapter 7 of the Bankruptcy Code.

There is a host of case law surrounding the above elements of Section 547 of the Bankruptcy Code, and a debtor's failure to prove each of these elements can serve as a viable defense to a preference action. While that discussion falls outside the scope of this article, there are affirmative defenses to preference actions that are discussed below.

The Bankruptcy Code provides a creditor-defendant with various affirmative defenses to a preference action. The more common of these defenses are discussed in this article. One such defense is the "subsequent new value defense." That defense allows a defendant to take a dollar-for-dollar credit against the alleged preferential transfers for certain new value extended after an alleged preferential payment was made. For example, if a creditor received a payment of $1,000 from the debtor within 90 days of a bankruptcy filing, and thereafter shipped $800 in goods to the debtor that remained unpaid as of the date of the bankruptcy filing, that creditor's preference exposure will be reduced to $200. A creditor's provision of new value is the most effective defense to a preference action and the simplest to prove.

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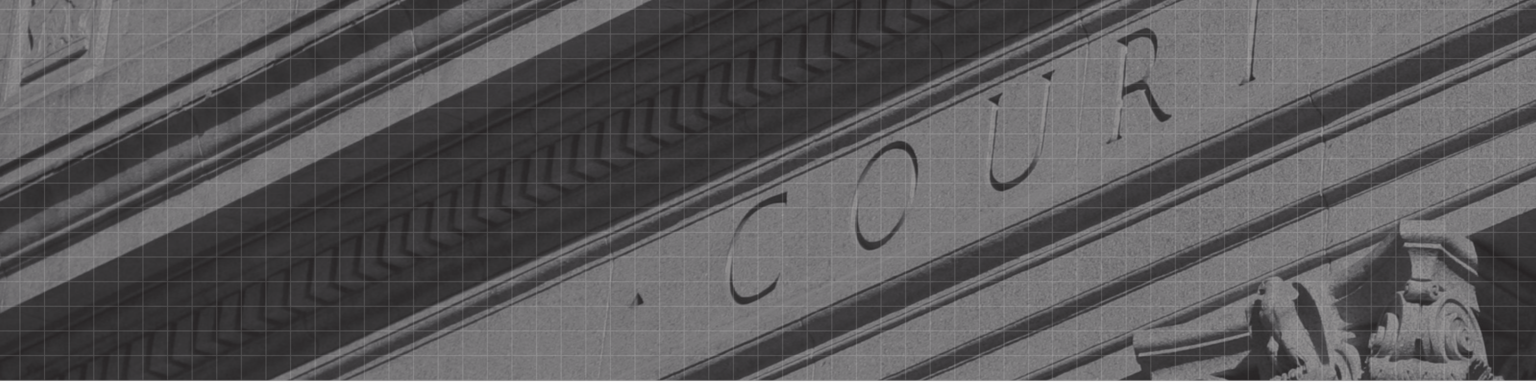
A second affirmative defense is the "ordinary course of business defense." Where a creditor has a history with the debtor, and the debtor has made the alleged preferential payments in accordance with its typical business practices with that creditor (or typical business practices of the industry), then those payments should be protected from a recovery by the debtor. The ordinary course of business defense, however, may not be available where a creditor takes unusual steps to collect those funds (even if they are paid in traditional terms), such as where a creditor makes multiple or harassing calls to the debtor or pressures the debtor for payments. But, where a debtor pays within terms and in a relatively routine manner, those payments should be shielded from attack.

The contemporaneous exchange for new value is a third affirmative defense. If you deliver goods to a debtor and then receive a payment nearly simultaneous with the delivery of those goods, it may be considered a contemporaneous exchange for new value which are immune from preference attack.

The above are only a few of the affirmative defenses that are available to shield a creditor from preference exposure.



THERE ARE TWO GOALS OF THE UNITED STATES BANKRUPTCY CODE. THE FIRST IS TO PROVIDE A DEBTOR WITH A "FRESH START." THE SECOND IS TO ENSURE THAT SIMILARLY SITUATED CREDITORS ARE TREATED FAIRLY AND EQUALLY IN A TRANSPARENT PROCESS.

Knowing the elements of a preference case and these affirmative defenses can serve to better protect a creditor from preference exposure. A creditor examining its trade dealings and credit policies should consider the following:

- Establish a credit limit for each of your customers, that is, without exception, not exceeded. This will limit your potential preference exposure because you will never receive a payment greater than the amount of the capped receivable.
- Explore your rights to become a secured creditor. If you are selling inventory and your customer has uncertain or questionable financials, sell that inventory on a consignment basis and establish a security interest in the goods.
- Obtain a letter of credit. Drawing on a letter of credit to pay for the goods and services sold to a customer will not be subject to preference attack.
- Explore your lien rights if you are in an industry that allows you to establish liens to enforce payment.
- Take a security deposit. Holding a security deposit will offset against any balance that might be owed and is certainly helpful. While there are rules about when you can and cannot setoff funds when you hold the security deposit, holding a security deposit will certainly provide leverage in a preference case.
- Consider dealing on a cash-only basis. To the extent that you receive checks from a customer, deposit the checks immediately. Holding checks risks greater preference exposure as courts look to the date that the checks cleared the debtor's account to determine whether the payment fell within 90 days of the bankruptcy filing.
- Keep your dealings with customers ordinary. Explore whether the payment terms you have extended to your customers are ordinary in the industry.
- Take prepayments. Prepayments cannot be subject to preference exposure because there is no antecedent debt on which they are made.
- Watch you customer's financials. Most importantly, keep on top of your customers and apprised of their financial situation. If their receivables start to climb, ask for the company's financials. If they are distressed, limit their abilities and ask them to prepay accounts.

These are only a few of the many issues that arise in connection with a preference defense. We encourage you to speak to your bankruptcy professional on how to tailor your own business dealings so that you are dealing with these issues on the front end as opposed to facing a lawsuit on the back end, as "an ounce of prevention is worth a pound of cure." D&B

[1] 11 U.S.C. §§101 et seq.
[2] This question – "[w]hy is there a preference law" was analyzed at length in an opinion issued by Judge Sontchi in In re Sierra Concrete Design, Inc., 463 B.R. 302 (Bankr. D. Del. 2012). The Sierra decision serves as a primer on preference law, with the Court ultimately finding that the answer to the foregoing question "lies in the answer to another question—why is there a bankruptcy law?" Sierra, 463 B.R. at 304. The reader is directed to the Sierra opinion for an easy primer on preference law and its purposes.
[3] See id.

Additional Information

For more information, please contact Jennifer R. Hoover at 302.442.7006 or jhoover@beneschlaw.com or Michael J. Barrie 302.442.7068 or mbarrie@beneschlaw.com.

For more information about our firm's diversity efforts, please contact Diversity & Inclusion Committee Chair E. Mark Young at myoung@beneschlaw.com or 216.363.4518 or Co-Chair James L. Ervin, Jr. at jervin@beneschlaw.com or 614.223.9325.

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