

BANKRUPTCY PREFERENCE CLAIMS & DEFENSES

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Bankruptcy Code:

- The Bankruptcy Code is part of the United States Code.
- It is federal law and preempts state law.
- In other words, the Bankruptcy Code is usually the last word on issues in bankruptcy cases.
- State law is important too, as long as it doesn't directly conflict with the Bankruptcy Code.
- State law also provides the substantive law when the Bankruptcy Code does not.

547(b): What is a preference? Also known as a "clawback."

- Per the Bankruptcy Code Section 547:
  - (b) Except as provided in subsections (c) and (i) of this section, the trustee may avoid any transfer of an interest of the debtor in property -
    - (1) to or for the benefit of a creditor;
    - (2) for or on account of an **antecedent debt** owed by the debtor before such transfer was made;
    - (3) made while the debtor was insolvent;
    - (4) made -
      - (A) on or within 90 days before the date of the filing of the petition; or
      - (B) between ninety days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider; and
    - (5) that enables such creditor to receive more than such creditor would receive if -
      - (A) the case were a case under chapter 7 of this title;
      - (B) the transfer had not been made; and
      - (C) such creditor received payment of such debt to the extent provided by the provisions of this title.

What are NOT PREFERENCES?

- Payments made on a secured debt up to the value of the collateral which secures repayment.
- Payments made in advance of the shipment of goods.
- Payments made in advance of providing services.
- Payments made to non-insiders more than 90 days before the filing.
- Transfers made when the debtor was still solvent.

What may be preferential transfers:

- Payments on an overdue invoice.
- Payments on a promissory note representing the sum of overdue invoices.
- The filing of a security interest in property pledged as collateral by the debtor.
- Payment on an invoice outside of the ordinary course of business of the parties.



Are there any defenses to a preference attack??

- Yes-but only those which are defined in the Bankruptcy Code and further refined in the case law.
- Even though the Bankruptcy Court is a court of equity, the court must follow the Bankruptcy Code in reviewing preference claims and defenses.
- Often the results seem very unfair—especially to creditors.

547(c) (1): Most common defense: Contemporaneous Exchange

(c) The trustee may not avoid under this section a transfer -

- (1) to the extent that such transfer was -
  - (A) intended by the debtor and the creditor to or for whose benefit such transfer was made to be a contemporaneous exchange for new value given to the debtor; and
  - (B) in fact a substantially contemporaneous exchange;

What is a contemporaneous exchange?

- Must the cash and the provision of goods/services occur at exactly the same time?
- No. Court have interpreted this to mean that the timing can be viewed more flexibly, depending upon the circumstances of the case, and a review of the relevant circumstances, such as the length of delay, reason for the delay, nature of the transaction and other circumstances.
- Some courts view a timely payment of a 30-day invoice as contemporaneous, others require a closer time period.
- This is a defense where you need legal representation to help you understand the rules in the court the case is pending in.



547(c)(2): Second defense: Ordinary Course

(2) to the extent that such transfer was in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee, and such transfer was—

- (A) made in the ordinary course of business or financial affairs of the debtor and the transferee; or
- (B) made according to ordinary business terms;

Ordinary course between debtor and creditor factors:

- the length of time the parties were engaged in the transactions at issue.
- whether the amount or form of tender differed from past practices.
- whether the debtor or creditor engaged in any unusual collection or payment activity.
- whether the creditor took advantage of the debtor's deteriorating financial condition.
- to assess what is "ordinary" among parties who have interacted repeatedly, the Court must "inquire into the pattern of interactions between the actual creditor and the actual debtor in question, not about what transactions would have been 'ordinary' for either party with other debtors or creditors."
- Conducting this inquiry requires the Court to first identify a baseline historical period reflecting the parties' typical payment practices.





Ordinary course in the industry:

- First the creditor must establish the "broad range" of business terms employed by similarly situated debtors and creditors, including those in financial distress, during the relevant period.
- Second, the creditor must show that the relevant payments were "ordinary in relation to [these] prevailing business terms."
- In general, § 547(c)(2)(C) should not pose a particularly high burden for creditors. See In re Jan Weilert RV, Inc., 315 F.3d at 1198 (holding only payments which are so unusual as to be "aberration[s] in the relevant industry" do not satisfy [§ 547(c)(2)(B)]).



547(c)(3): Third Defense: PMSIs

- (c)(3) that creates a security interest in property acquired by the debtor -
  - (A) to the extent such security interest secures new value that was -
    - (i) given at or after the signing of a security agreement that contains a description of such property as collateral;
    - (ii) given by or on behalf of the secured party under such agreement;
    - (iii) given to enable the debtor to acquire such property; and
    - (iv) in fact used by the debtor to acquire such property; and
  - (B) that is perfected on or before 30 days after the debtor receives possession of such property;

547(c)(4): Fourth defense: New Value

- (c)(4) to or for the benefit of a creditor, to the extent that, after such transfer, such creditor gave new value to or for the benefit of the debtor -
  - (A) not secured by an otherwise unavoidable security interest; and
  - (B) on account of which new value the debtor did not make an otherwise unavoidable transfer to or for the benefit of such creditor;



When does the transfer occur?

(2) For the purposes of this section, except as provided in paragraph (3) of this subsection, a transfer is made –

- (A) at the time such transfer takes effect between the transferor and the transferee, if such transfer is perfected at, or within 30 days after, such time except as provided in subsection (c)(3)(B)…
- (C) immediately before the date of the filing of the petition, if such transfer is not perfected at the later of –
  - (i) the commencement of the case; or
  - (ii) 30 days after such transfer takes effect between the transferor and the transferee.
- (3) For the purposes of this section, a transfer is not made until the debtor has acquired rights in the property transferred.

- In plain English:
  - When the check or wire actually clears the debtor's account.
  - When the debtor receives the goods or services.
  - When an act needed to perfect the transaction occurs.

Who can be liable?

- Liability of transferee of avoided transfer
  - (a) Except as otherwise provided in this section, to the extent that a transfer is avoided under section 544, 545, 547, 548, 549, 553(b), or 724(a) of this title, the trustee may recover, for the benefit of the estate, the property transferred, or, if the court so orders, the value of such property, from -
    - (1) the initial transferee of such transfer or the entity for whose benefit such transfer was made; or
    - (2) any immediate or mediate transferee of such initial transferee.
  - But can only recover once!



Who may not be liable?

- (b) The trustee may not recover under section (a)(2) of this section from -
  - (1) a transferee that takes for value, including satisfaction or securing of a present or antecedent debt, in good faith, and without knowledge of the voidability of the transfer avoided; or
  - (2) any immediate or mediate good faith transferee of such transferee.





Calculate your claim and evaluate risks:

- Calculate claims:
  - Gather all documents related to the claim - all receipts signed & the like
    - Review all outstanding invoices
    - Reduce claim by any agreed returns or credits
    - Determine whether customer has disputed any part of the claim- determine whether you agree with the dispute
      - If yes-apply to reduce claim
      - If no-disregard for purposes of calculation
    - After calculating claim amount
      - Determine if any interest or late fees accrued before petition date-if so, add to claim
- Identify whether claim is secured by any liens or retainage-check to see if properly filed.
- Do you have a 503(b)(9) claim:
    - Did you deliver goods within 20 days of filing?



Identify potential issues:

- Preference actions:
  - Did you receive payment within 90 days of the petition date?
  - Was the payment made on an outstanding invoice or was it a payment in advance or at the time of delivery?
  - Does the plan on file (if any) provide for less than full payment to unsecured creditors?
  - Did you continue to ship after receipt of payment?
  - Was the payment made in the ordinary course of dealings between you and customer or within the industry?
  - If multiple debtors-did the same company that received goods/services pay for them?

Preference demands are often sent to you in a letter from a trustee.

- Do not ignore the letter.
- Research the facts.
- Consult counsel.
- Develop a plan of action!
- If you don’t respond, the next step will likely be the receipt of a lawsuit.



Subchapter V Comments

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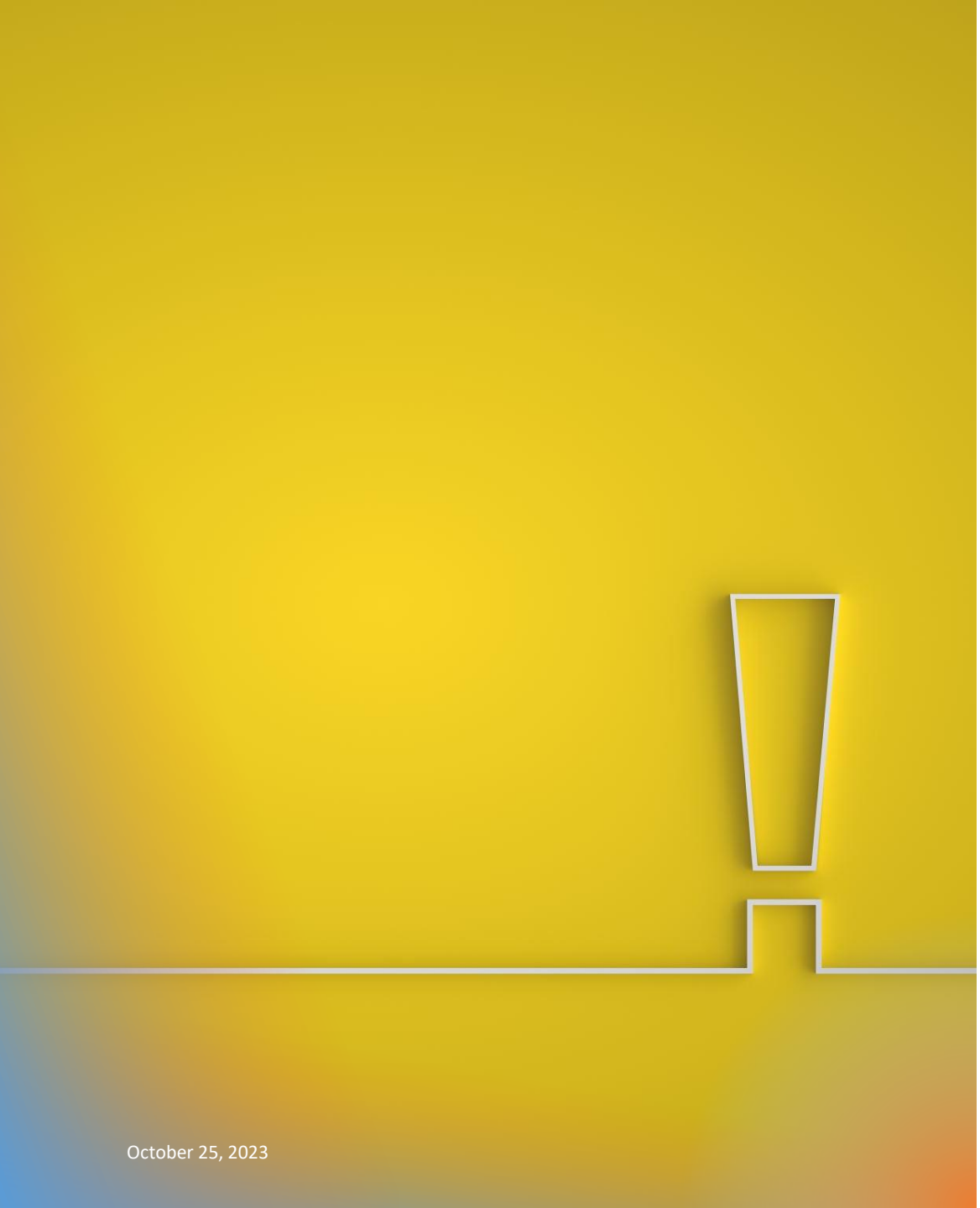
What is Subchapter V?

- A new provision of the Bankruptcy Code
- Designed to help small businesses file bankruptcy, confirm a plan and exit the process quickly to reduce the time and fees usually required.
- To be eligible, a debtor must have debt at or below $7.5 million (excluding insider debt).
- The process is streamlined:
  - No creditors' committee unless the court approves one
  - An abbreviated disclosure statement can be incorporated into the plan and doesn't need to be separately approved.
  - Only the Debtor may modify the plan.
  - The absolute priority rule does not apply so the owners may retain their interest in the debtor even though creditors are not paid in full.
  - The plan can be confirmed without an accepting creditor.
  - The rights of a lender secured by a residence may be modified.
  - No voting is required.
- A subchapter V trustee will be appointed.

This process creates challenges for creditors!

- Deadlines are short.
- Creditor remedies are reduced.
- The Debtor has the ability to keep everything and pay almost no creditors.





Be Assertive!

- Consider objecting early to the Subchapter V designation if the debtor is ineligible.
- Utilize chapter 11 creditor remedies, such as critical vendor status and 503(b)(9) priority status claims.
- Consider asking the court to direct appointment of a creditiors' committee for cause.

The Subchapter V Trustee is not a fiduciary for unsecured creditors!

- Creditors can seek to have Subchapter V Trustee investigate possible claims against the Debtor and third parties, such as insiders.

- Creditors must seek court approval.



Challenge the plan!

- Debtor must contribute all projected disposable income to the plan.
- Creditors should be prepared to examine the Debtor's projections, which can be manipulated.
- Creditors could seek to expand plan period to 5 years.
- Creditors could seek recovery of the upside if the Debtor exceeds projections.
- Creditors should consider working with Trustee on plan issues.
- Object to any extended repayment of administrative claims under the plan



What is in the works for Subchapter V?