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PREFERENCE ACTIONS AND FREQUENTLY ASSERTED DEFENSES

In light of the worldwide economic recession and expected increase in bankruptcy filings, debtors are likely to bring an ever-increasing number of preference actions against creditors in an effort to recover alleged preferential transfers. This Client Advisory outlines the defenses and rebuttals to these types of claims available to creditors and certain pre-payment actions that creditors may take in order to mitigate future preference liability.

In order to discourage creditors (particularly those with greater influence over the debtor) from consuming available assets prior to bankruptcy and to promote equal treatment among creditors, Section 547 of the Bankruptcy Code (the "Code") permits a trustee or debtor-in-possession to set aside and recover certain "preferential transfers," so long as the transfer satisfies each of the following elements:

1. Prior to the bankruptcy filing, the debtor transferred an interest in property;
2. The debtor transferred the interest to, or for the benefit of, a creditor;
3. The debtor transferred the interest to pay or secure an obligation owed to the creditor prior to the transfer (an "antecedent debt");
4. The debtor was insolvent at the time of the transfer;
5. The transfer occurred within ninety (90) days before the bankruptcy petition date (the "preference period"), or, if the transfer was made to or for the benefit of an "insider" of the debtor, within one (1) year prior to the petition date (the "insider preference period"); and
6. The transfer permitted the creditor to receive more than it would have received upon Chapter 7 liquidation of the debtor.

Additionally, the claim must be filed within two (2) years from the date of the bankruptcy filing, and Section 547(c)(9) of the Code bars actions for "De Minimis Transfers" if the monetary threshold of $6,825.00 is not met. The amounts may not be aggregated across creditors in order to satisfy this monetary threshold.

Generally, unsecured creditors who received a transfer within the preference period are most vulnerable to a preference claim. Secured creditors who failed to properly or timely perfect security interests in collateral, or whose collateral dramatically decreased in value during the preference period, are also vulnerable to a preference claim. If the debtor can successfully assert a preference, it can cancel the transaction and force the return of the payments or property. On the other hand, if the creditor can successfully assert one of the available defenses to a preference action, it may keep the payment or property.

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When a debtor or trustee satisfies all of the elements of a preference action, the burden then shifts to the preference defendant to reduce or eliminate the preference exposure by either (i) rebutting one of the elements of a valid preference action or (ii) successfully raising one or more of the preference defenses available under the Code. The following tables are intended to assist companies and their advisors in considering various rebuttals and defenses to preference actions available to them under the Code.

Rebuttals and Common Defenses

The below table provides an overview of frequently asserted rebuttals to various elements of a preference action.

Rebuttal	Element Rebutted	How to Rebut Element	General Guidance / Examples
Not Property of Debtor	Element 1 not satisfied	Must show that the property transferred was not the property of debtor.	Guidance – Only transfers made by the future bankruptcy debtor can be preferential. Example – If a related entity or a third party, such as a guarantor, repays a creditor of the debtor, the preference action fails because the debtor's property was not used to make the repayment.
Payments Not Received by Creditor	Element 2 not satisfied	Must show that the payment was not received by the creditor. When determining when a payment has been "made" during the preference period, the Code states the payment is made on the date the check is cleared.	Guidance – Review to ensure all payments that the debtor claimed as preferences were actually received by the creditor. Guidance – Request a list of all checks that make up the preference claim and copies of all (i) cancelled checks; and (ii) proof of wire transfers with remittance instructions. Also review to see if any of the claimed check payments were bounced.
Cash-In-Advance	Element 3 not satisfied	Must show that the payments were cash-in-advance ("CIA") payments. CIA payments are not preferences because they are not payments on antecedent debt. Creditor will not receive payment on account of an antecedent debt under a CIA system, resulting in element 3 failing at the outset.	Pre-Bankruptcy Guidance – Switch troubled customers to a CIA regime. CIA payments are those that are paid in advance of shipment of goods or the provision of services.

Rebuttal	Element Rebutted	How to Rebut Element	General Guidance / Examples
Solvency	Element 4 not satisfied	Must show the debtor's assets actually exceed its liabilities. Debtor is presumed to be insolvent during the ninety (90) days immediately preceding the date the bankruptcy petition was filed.	<u>Guidance</u> – Check bankruptcy schedules and financial statements covering the preference period or shortly before the preference period. The recipient or beneficiary of the transfer can present evidence to rebut the presumption, and if successful, the debtor must prove insolvency.

Even if all elements of a preference action are established, a creditor may still defend against such claim by using one or more of the following defenses, and taking certain actions in advance of a preference action may permit the creditor to better position itself to prevail over a trustee or debtor-in-possession's attempts to claw back payments.

Preference Action Defense	When It Applies	Requirements / Determination	Examples / General Guidance
Ordinary Course of Business ➢ 547(c)(2)	Where the preferential transfer was made in payment of a debt incurred by debtor in the ordinary course of business or financial affairs of debtor and creditor.	Two elements apply: (i) the debt being repaid must have been incurred in the ordinary course of business of both debtor and creditor; and (ii) the repayment must have been made either (a) in the parties' ordinary course of business or financial affairs (subjective standard) or (b) according to ordinary business terms applicable to the relevant industry (objective standard).	<u>Pre-Bankruptcy Guidance</u> – Establish a "baseline of dealing," harping on regularity and consistency in business dealings. Establish open lines of communication with debtors early in the business dealings regarding payment of invoices, extending regular demands for payment, deciding a temporal threshold for accepting late payments and discussing the potential of cash-on-delivery terms being implemented in the event of repeated late or non-payment. <u>Example</u> – Creditors should demand upfront that payment will only be accepted in a particular manner (e.g., by online payment, check, etc.) and then hold debtor to that standard throughout the course of their dealings. Consistent, regular invoices are preferred. <u>Guidance</u> – Courts look at a multitude of factors when deciding whether a baseline of dealing has been reached, including: (i) the length of the parties' relationship; (ii) the relative size of multiple transfers; (iii) the manner of tender of payments; (iv) any unusual

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			action by either party to collect or pay on the debt; and (v) whether creditor gained an advantage in light of debtor's financial hardship (i.e., gaining additional security). Late payments, by themselves, are not determinative evidence to defeat an Ordinary Course of Business Defense, so long as that was the standard course of dealing between the parties; however, the degree of lateness cannot deviate too much between the preference period and the baseline period. Unusual collection actions and activities such as persistent phone calls and emails seeking payment of past-due invoices can be enough evidence to take the transfers outside of the ordinary course of business if there is no precedent for such conduct during the parties' baseline period. Collection actions taken during the preference period, including accelerating payments after making threats and demands, are also likely to defeat this defense.
Contemporaneous Exchange for New Value ➢ 547(c)(1)	Applies to cash-on-delivery transactions or payments in exchange for waiver or release of lien rights against debtor's property.	Two elements must be met: (i) the transfer must be intended by the parties to be a contemporaneous exchange for "new value" given to debtor (i.e., the debtor received new value in exchange for the payment); and (ii) the transfer must have occurred at a time "substantially contemporaneous" with the time the debt arose. Courts have interpreted "substantially contemporaneous" to mean that the parties executed an exchange of goods or services for	New Value Example – "New Value" is given where a creditor provides new goods and/or new services or waives lien rights fully secured by debtor's assets in exchange for a payment or other transfer. A debtor receiving goods in exchange for cash or receiving a loan guaranty from a creditor are two additional examples of new value. New value may also include the extension of new credit, but new value is not created if a new obligation is substituted for an existing obligation (e.g., one guarantor taking the place of a previous guarantor). Substantially Contemporaneous Guidance – Payment made within 10 days of provision of goods or

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		payment that was “as simultaneous as realistically possible.”	services or waiver of a lien satisfies the “substantially contemporaneous” requirement. The further outside of this 10-day period, the less likely the transfer is viewed as “contemporaneous.”
Enabling Loans (Perfected PMSI) ➢ 547(c)(3)	Applies protection where a creditor extends new value to debtor, enabling it to purchase property, in exchange for which the debtor transferred to the creditor a security interest in the property acquired with the new value (PMSI).	Debtor must sign a security agreement describing the property to be purchased and granting the security interest in this property to the creditor.	Guidance – A creditor needs to perfect the security interest in accordance with applicable state law and within 30 days after debtor takes possession of the property in which the security interest was granted.
Subsequent Advance of New Value ➢ 547(c)(4)	Available where the creditor had provided new value (i.e., shipping additional goods or providing services) to the debtor prior to the preference. This defense is designed to protect a creditor to the extent the creditor provided new goods or services subsequent to the preference and protects unsecured creditors who extend further unsecured credit or other new value after receiving a preferential transfer from the debtor.	New loan must (i) be unsecured; (ii) occur after the creditor received a preferential transfer from debtor; and (iii) not be conditioned on receiving another transfer from debtor. Creditor should prepare a new value analysis to determine the net preference exposure after deducting the new value. New value is determined by offsetting the value of new goods and/or services from only prior (not subsequent) preference payments during the 90-day preference period. New value is calculated as of the date it was provided (to include the invoice date or date goods are shipped). If a lender extends an additional loan after receiving a payment	Guidance – Courts disagree about the application of this defense. Most courts have held that a subsequent advance shelters prior payments made by the debtor, not only the payment immediately preceding the subsequent advance. This is known as the “plain meaning” or “subsequent advance” approach, and has been adopted by the majority of courts. This is a creditor-friendly approach because new value does not remain unpaid. Instead, this approach allows creditors to move preferences forward until they are exhausted by subsequent advances of new value. However, the minority court approach, known as the “remains unpaid” approach, holds that the new value must remain unpaid for this defense to apply. Administrative priority claims are usually not considered new value. The purpose of this defense is to encourage creditors to continue to do business with troubled companies, while replenishing the estate.

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		from debtor, then the payment will not be treated as a preference to the extent of the amount subsequently advanced.	In effect, goods or services provided on credit terms following a preference payment reduce preference exposure dollar for dollar. The sequence of events is crucial to this analysis. <u>Example</u> – A creditor ships debtor \$10,000 of goods on January 1st, and debtor repays \$5,000 to creditor on January 2nd. On January 3rd, creditor ships debtor an additional \$3,000 worth of goods, and on January 30th debtor files a bankruptcy petition. While the January 2nd payment of \$5,000 was a preference payment, only \$2,000 of that preference payment could be recovered by debtor under a preference action because the potential claim is reduced by the amount of the January 3rd shipment valued at \$3,000. On the other hand, if creditor did not make the additional January 3rd shipment, it would have to return the entire \$5,000 to debtor's estate because the \$10,000 shipment of goods occurred before the preference payment, and creditor would be left with a \$10,000 unsecured claim against the estate.
Statutory Liens ➢ 547(c)(6)	Certain liens under Section 545 of the Code are potentially "avoidable" as preferences and thus exempt from preference actions.	The statutory lien must be an avoidable lien outlined in Section 545 of the Code, which includes liens based on financial distress, unperfected liens that cannot be enforced against a bona fide purchaser, liens for rent and liens of distress for rent. Statutory liens which do not fall into any of the categories provided in Section 545 of the Code may not be exempted from preference actions.	<u>Guidance</u> – As a general matter, any liens created automatically by statute cannot be avoided as preferences. These include tax liens and mechanic's liens. These statutory liens are only exempt from preference actions if they meet the standard under Section 545 of the Code.

Preference Action Defense	When It Applies	Requirements / Determination	Examples / General Guidance
"Earmarking" Doctrine	Applies where a third party provides funds to the debtor for the express purpose of enabling the debtor to pay a specified pre-existing creditor, thereby substituting a new creditor for an old creditor.	Two elements must be met: (i) the transaction as a whole must not diminish the debtor's estate; and (ii) the debtor must have no control over how the funds are used.	Example – Debtor repays a creditor using a third party's funds. The third party must have directed the debtor to use the money to satisfy the debt, with the debtor having no control over how it could otherwise use the third party's funds.
Assumed Contract	Applicable where an executory contract (a contract not yet fully performed or fully executed) is assumed by the debtor.	Once the debtor assumes an executory contract, it may not bring a preference action to recover prepetition payments made under that contract.	Guidance – A contracting party is entitled to receive all amounts it is owed under the assumed contract, including amounts received during the preference period.

The foregoing is intended to provide a brief summary of the matters addressed herein. It is intended to be informational and does not constitute legal advice regarding any specific situation.