BANKRUPTCY LAW

A Road Map for Lenders Defending Preference Actions

by John G. Loughnane

A borrower files for bankruptcy, and the lender is asked to return payments made before the bankruptcy. What's a lender to do? In the following article, the author sets forth the legal framework of a preference case including the six elements of a preference and five common defenses to preference liability. The article concludes with five practical items that a lender should consider in defending against a preference claim.

A lender whose borrower has filed for bankruptcy protection incurs the expense and irritation of attempting to ensure recovery of the loan. Just when that ordeal seems to be wrapping up, the bankruptcy procedure can add insult to injury: A pithy letter may be received asking that the lender return payments received before the bankruptcy on the basis that the payments constitute "avoidable preferences." Although some letters invite the lender to "share" information concerning any defenses that may be available, other letters "require" the immediate return of the funds.

The lender should gather the facts concerning the payment and develop a defense against a preference action with the following two issues in mind:

1. Is negotiation and settlement of the claim desirable and achievable?

2. To what extent, if any, is the expense of litigation likely to lead to an acceptable settlement or to a favorable judicial determination?

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The Legal Framework of a Preference Case

What is a preference? A preference consists of six legal elements embedded within the following definition: A preference is a transfer of the debtor's property to or for the benefit of a creditor, for or on account of an antecedent debt, while the debtor was insolvent, within 90 days before bankruptcy (or within one year before the petition if the payment is to or for an "insider," as such term is defined in the Bankruptcy Code), and the effect of which transfer is to give the creditor more than it would have otherwise received in a Chapter 7 distribution. For ease of reference, this article assumes that a bankruptcy trustee is the party seeking recovery of the preference.

1. Transfer of an interest of the debtor in property. The trustee first must establish that payment to the lender constitutes a transfer of an interest of the debtor in property. Transfer is broadly defined by the Bankruptcy Code to mean every mode of disposing of or parting with an interest in property. Despite the breadth of that definition, it is clear that it does not include property that ostensibly belongs to the debtor and is, in reality, held by the debtor in trust for another.

2. To or for the benefit of a creditor. The Bankruptcy Code defines a creditor as an entity with a claim against the debtor that arose before the bankruptcy filing. In the typical case, there is no dispute about a lender that directly received a challenged payment having a right to such payment.

3. Antecedent debt. Essentially, a debt is antecedent if it is incurred before the transfer is made. The antecedent debt element will not be satisfied unless the debtor did not become obligated to pay until after the transfer occurred.

4. Insolvency. The trustee is entitled to a presumption of the debtor's insolvency during the 90-day period preceding the bankruptcy filing. No such presumption exists for the one year reachback period applicable to insiders. To rebut the presumption of insolvency, the lender must demonstrate that the debtor's liabilities did not exceed its assets at the time of the transfer. In many cases, the lender will not be able to rebut the presumption without incurring significant expenses. If, despite the presumption, the insolvency issue appears to offer fertile ground for a possible defense, it is worth exploring whether other parties in the bankruptcy case, such as other preference defendants, have sought or seek to establish the debtor's solvency.

5. Timing. The challenged payment must also be made within the 90-day period before the bankruptcy filing. Check payments are deemed made on the date the check is honored. The trustee can seek to avoid payments made within one year before the filing if he or she can establish that the creditor to or for whose benefit the payment was made was an insider at the time of the transfer. Although trustees are normally careful to challenge only payments made

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within the prescribed time frames, the matter should be checked. The Bankruptcy Reform Act of 1994 amended the Bankruptcy Code to provide that noninsider transferees have no liability for preferential payments made for the benefit of insiders during the period between 90 days and one year before the filing of the bankruptcy petition. It is not clear whether the amendment applies to liens granted to a noninsider that benefit an insider.

6. Preferential effect. To carry the burden on this element, the trustee must prove that the lender received more from the estate than it would have received if the transfer had not been made and the case were filed originally under Chapter 7 of the Bankruptcy Code. Lenders often find comfort in the well-settled rule that transfers to an undersecured perfected first-priority creditor towards satisfaction of its debt cannot be preferential.

Statutory Defenses to Escape Liability

Even if the trustee successfully alleges and proves all six elements of a preference, the lender can escape liability by virtue of any one of several exceptions to liability, five of which are discussed here.

1. Contemporaneous exchange of new value exception. Transfers are not avoidable that are intended to be a contemporaneous exchange for new value and that are, in fact, substantially contemporaneous. The classic transaction protected by the contemporaneous new value exception is a check transaction in which the debtor writes a check for goods or services that become part of the debtor's estate. Because a check transaction is normally considered a credit transaction, the payment of the check, which typically occurs after the delivery of the goods, would constitute an avoidable preference. The contemporaneous new value exception recognizes that such transfers are intended to be, and substantially are, contemporaneous transfers that have no net effect on the debtor's estate: The value of the check is replaced by the value of what the check purchased.

2. Ordinary course of business exception. Payments made in the ordinary course of business are not avoidable when three distinct elements are satisfied:

1) The payment was for a debt that was incurred by the debtor in the ordinary course of its affairs with the lender.
2) The transfer itself was made during the ordinary course of these affairs.
3) The transfer was made according to ordinary business terms.

To succeed on this defense, the lender must show that each payment was consistent with the prior course of dealings between the parties. A lender need not prove that the alleged preferential payment mirrors payments during the prepreference period; general consistency with prior payments is all that is required. The lender should also demonstrate that it did not make any effort to receive any special treatment regarding payment of its bills during the preference period. And a lender must demonstrate that each alleged payment was made according to ordinary business terms, which most courts have held requires the lender to prove that the transaction conforms to industry standards. Unfortunately, neither Congress nor the courts have set forth clear standards by which industry norms will be judged. A lender relying on the ordinary course of business defense should, at a minimum, gather evidence of its relationship with customers similar to the debtor as well as details concerning its competitors' relationship with the debtor and parties similar to the debtor.

3. Enabling loan exception. A security interest securing new value to enable the debtor to acquire property is not a preference if perfected within 20 days after the debtor obtains possession of the property. This defense is designed to conform to Uniform Commercial Code rules governing purchase money security interests.

4. The subsequent extension of new value defense. Any new value extended subsequent to an alleged preferential payment can be used to offset prior preferential payments. Many courts have stated that the following three part test governs application of the exception:

1) The creditor must have extended the new value after receiving the preference.
2) The new value must have been unsecured.
3) The new value must remain unpaid.

The defense is most applicable to a creditor that regularly supplies new goods or services to a debtor.

5. Floating liens. A transfer of property that creates a perfected security interest in the debtor's

Figure 1 Questions to Ask

- Does any evidence exist indicating that the challenged payment does not constitute a transfer of an interest of the debtor in property?
- Does any evidence exist that the transfer was not made to or for the benefit of a creditor?
- Does any evidence exist that the transfer was not for or on account of an antecedent debt owed by the debtor before such transfer was made?
- Does any evidence exist that the debtor was solvent when the transfer was made?
- Was the transfer made within 90 days before the petition date? Is there any evidence that the recipient was an insider so that the one year reachback period applies?
- Did the recipient have any right of setoff or recoupment or was it in any way a secured creditor? If the bankruptcy case had been instituted as a Chapter 7 case, would the recipient have received a greater distribution?

inventory, receivables, or proceeds of either is not avoidable only to the extent that the creditor has not improved its position within the preference period.

Practical Considerations in Defending a Preference Avoidance Action

The following five points should be considered by a lender in determining the best way to extricate itself from a preference action at the lowest possible cost.

1. Gather facts. Appropriate legal arguments can only be formed when relevant factual information has been pulled together. The questions in Figure 1 are designed to elicit useful facts relevant to the six preference elements and five exceptions discussed in this article. Each question should be considered to determine whether further information or documents should be obtained. The usefulness of the subsequent new value defense and the ordinary course defense is best determined when the prepetition relationships between the parties is summarized in chart form.

2. Know the trustee and his or her settlement authority. Often a trustee will dispose of a preference case by agreeing to a settlement figure that is reasonably supported at the early stages of the case before an expenditure of significant resources. This early period is an excellent opportunity to judge whether to settle with little litigation costs. However, the decision to make a settlement offer early in the case should only be made after an understanding of the strengths of the defenses and any weakness in the trustee's case is obtained. If more time is needed to

when Gathering Facts

- How long have the defendant and debtor been doing business?
- What is the nature and extent of their relationship? (How many transactions per week/month/year; has this changed within the two years before the bankruptcy filing?)
- Was the payment in fact contemporaneous with a shipment of new value? Was it intended to be?
- Was the payment on account of an obligation incurred in the ordinary course of the debtor's business?
- Was the payment made in the ordinary course of the parties' transactions?
- What is the practice in the industry? Are there others in the industry that can state the challenged payment is consistent with payment in the industry?
- Was any new value provided subsequent to the transfer?
- Is any statute of limitations defense applicable?

undertake this analysis, an extension of the answer date can certainly be requested. Pursuant to the bankruptcy rules, a court may approve a compromise or settlement proposed by a trustee. The standards for approval require the court to inquire into the reasonableness of the proposed settlement. To ease case administration, it is not unusual for a trustee to seek, before the institution of preference actions, authority to settle preference adversary proceedings within specific ranges. Indeed, the trustee's counsel will typically share this information willingly in an effort to guide the matter towards settlement.

3. Know the bankruptcy case, the judge, and the court. The preference litigation phase of a bankruptcy case typically occurs after some lengthy period of activity during the main case. The lender should have counsel obtain and review the docket for the main case on a regular basis to monitor whether any relevant issues surface. It is helpful to know how the judge has decided prior preference issues.

4. Know the amount of any claims against the debtor and any unasserted claims the trustee may possess. By the time the preference action has been instituted, the lender may have filed a proof of claim against the debtor's estate. The lender should find out what distribution is expected for allowed claims and the expected timing of the distribution. At the appropriate time, it is necessary to ensure that any settlement payment on the preference action made is deemed added to the filed proof of claim. More important, it is critical to fully analyze whether the trustee has failed to challenge any payments received by the lender during the preference period. Sometimes the trustee will have overlooked wire transfers or have conducted an incomplete analysis of the debtor's books and records. Obviously, the trustee retains an ability to amend the complaint. Although the right to amend is not without limits, courts generally take a fairly liberal view. The lender's view of the case may well be shaped by payments that have not been challenged initially by the trustee but may soon be discovered and added.

5. Understand the fraudulent transfer card. Some trustees seek avoidance of alleged preferential payments as actual or constructively fraudulent transfers. An actual fraudulent transfer occurs when an insolvent debtor gives valuable assets to friends and affiliates for the sole purpose of keeping such assets from creditors. A constructive fraudulent transfer occurs when, regardless of the debtor's state of mind, the debtor receives less than fair value for transferred assets. The Bankruptcy Code allows a trustee to seek avoidance and recovery of fraudulent transfers made or incurred within one year before the bankruptcy petition. Thus, the trustee's power to avoid fraudulent transfers can dramatically affect the total amount sought by the trustee.

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The issue for the lender is determining how much credibility to give a trustee's inclusion of a fraudulent transfer count alongside a preference count. The trustee may avoid a payment as an actual fraudulent transfer only if it was made with "actual intent to hinder delay or defraud any creditor" to which the debtor was or became obligated at the time of transfer. To succeed on this count, the trustee must plead facts indicating the existence of actual intent to defraud or demonstrating circumstantial evidence of actual fraudulent intent. A lender should refuse to be intimidated into a higher settlement merely because the trustee has included an actual fraudulent transfer allegation. The lender should be aware, however, that one court recently upheld an actual fraudulent transfer count against a lender that accepted payments on its loan when the payments were deemed not avoidable as preferences. (See *In re Terrific Seafoods*, 197 B.R. 724 (Bankr. D. Mass. 1996).)

The trustee may only avoid as constructively fraudulent a transfer for which the debtor voluntarily or involuntarily "received less than a reasonably equivalent value in exchange for such transfer or obligation." A trustee has the burden of proving all the elements of a constructive fraudulent transfer. The Bankruptcy Code provides, in part, that "value" means "property, or satisfaction or securing of a present or antecedent debt of the debtor." When a debtor satisfies an antecedent debt owed by it to the creditor, the debtor obtains value within the clear meaning of the Bankruptcy Code. Transfers that satisfy an antecedent debt thus are not avoidable as fraudulent transfers. If this slam dunk defense applies, the lender should not give the count any credibility in settlement discussions. Of course, unless inclusion of the count can be shown to be clearly frivolous, litigation risk and expense must be factored into any settlement proposal.

Conclusion

Many lenders are completely shocked by a trustee's power to seek avoidance and recovery of payments made by a debtor to the lender before the bankruptcy case filing. The basic information provided in this article should help the lender:

- Better understand when the acceptance of transfers from a financially troubled entity may be subject to attack in a subsequent bankruptcy proceeding.
- Know when to encourage a trustee to pursue other recipients of prepetition payments to increase the amount of the debtor's assets and, thus, the recovery on any unsecured claim the lender may hold.
- Ensure that discovery and litigation, if employed at all, are conducted in a cost effective manner.❐