Advantage to Creditor: Understanding Preference Actions and Available Defenses

By Edward S. Margolis

For many lawyers, knowledge of bankruptcy law is limited to breaking the bad news to creditor clients that they are not likely to get paid by a bankrupt debtor. The explanation I give my commercial clients for their misfortune: it's in the United States Constitution, Article I, section 8, clause 4.1 Sometimes I file a proof of claim for a client, but most of the time, they can do it themselves for what it is worth.

But what if that same commercial creditor client, some 20 months later, calls and says it is being dunned by a collection agency or an attorney on behalf of the bankrupt's estate, who demands that the client return a "preference payment "for services performed or goods delivered some two years before?

Here the explanation becomes a little dicey. The United States Constitution, which I mentioned earlier, leaves it to the legislative branch of government to make up the rules of bankruptcy, and those rules create something called a "preference"- a transfer by the debtor a short time before he files for bankruptcy that treats one creditor more favorably than similar creditors. The power to avoid preferences promotes the primary bankruptcy policy of equality of distribution among creditors by insuring that all creditors of the same class receive the same pro rata share of the debtor's estate.2

Actions to avoid preferences - advantage to debtor

An action to avoid preferences is a strange bird. Among the peculiarities of the species is that it has no respect for territory. The fact that your client has never set foot on the soil of Illinois and has no "minimal contacts," as that term is known in the law, will get no sympathy in bankruptcy court.3

Adding to the inconvenience of the forum, the bankruptcy court shows its further disrespect for due process by allowing service by U.S. mail.4 In other words, your client could be hailed into a court in a jurisdiction where it has no minimal contacts through a summons placed in an envelope which arrives at your client's place of business along with the usual batch of junk mail.

Most preference actions are filed after at least some pre-suit attempts on the part of the trustee to collect. There is, however, a statute of limitations that requires that preference actions be filed within two years of the date of the filing of the bankruptcy.5 Sometimes the decision to file these actions and the selection of counsel for the trustee comes late in the game, meaning that preference actions are filed and summonses sent at the last minute to beat the statute.

In any event, whether the first contact with the trustee is through a pre-suit demand or by actual receipt of the summons in the mail, the intervention of legal counsel for the creditor is critical at this point.

In addition to the enormous power of the bankruptcy court to exercise jurisdiction over your client, the rules that give rise to the trustee's action to avoid a preference are unbalanced in favor of the trustee. To make a case, the trustee need only establish that the bankrupt made a payment while insolvent to the creditor for an antecedent debt within 90 days of the bankruptcy filing that resulted in the creditor obtaining a greater distribution then it would have received upon a liquidation of the bankrupt's assets under the provisions of the bankruptcy code.6 Since insolvency of the bankrupt is presumed within 90 days of the bankruptcy,7 it would appear that the trustee need only look at the bankrupt's ledger and then proceed to sue every supplier of the bankrupt to which payments were made during the 90-day preference period.

At this point, things are definitely not looking good for the creditor. As indicated, this client may have sought your legal advice when he received the initial bad news of the bankruptcy. Now, to add insult to injury, the bankrupt has arisen from the dead and is seeking return of payment for goods and services your client provided in good faith some two years before.

Affirmative defenses - some post-BAPCPA changes

By filing the preference action, the trustee has made a prima facie case. All is not lost, however, at least not necessarily. The ball is now in your court to raise any available affirmative defenses among those provided in the bankruptcy code. Here are the three most common defenses, one of which has been made more attractive by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA").8

Defense #1: payments in the ordinary course of business. The rationale behind this defense is "to leave undisturbed normal financial relations, because it does not detract from the general policy of the preference section to discourage unusual action by either the debtor or his creditors during the debtor's slide into bankruptcy."9 To qualify under this exception, the creditor must prove that (1) the debt underlying the payment was incurred in the ordinary course of business between the debtor and the creditor and10 (2) the payment was made in the ordinary course of business of the debtor and the creditor or11 (3) according to ordinary business terms.12

The court in determining this defense will examine such factors as the prior course of dealings between the parties and the amount, timing, and circumstances of the payments.13

Basically, the creditor must show that the transaction in question was usual between the parties and that the intrval between rendering the services or providing the goods and payment was likewise usual. This type of proof can generally be developed by examining the creditor's records and comparing the interval between invoice and payment during the preference period with the prior course of dealings between the parties.

Under the old bankruptcy code, the creditor's burden did not end at this point. Instead, creditors were obliged to establish that the ordinary course of dealings was also common in the creditor's industry, requiring a creditor to present expert testimony to establish the industry standard.14

Fortunately for creditors, this is no longer necessary under the BAPCPA. Under the revised act, the creditor need only prove that the payments were in the ordinary course of business between the parties or in the ordinary course of business within the industry, not both.15

Our seventh circuit court of appeals has ruled that "'ordinary business terms' refers to the range of terms that encompasses the practices in which firms similar in some general way to creditor in question engage."16 The BAPCPA puts the creditor on a level playing field with the trustee by providing that "only dealings so idiosyncratic as to fall outside the broad range should be deemed extraordinary and therefore outside of the scope of subsection [B]."17 A creditor will now, within its own records, be able to establish whether the payments were in the ordinary course of business.

Defense #2: payments that represent the simultaneous exchange of new value. A transfer may not be avoided if the alleged preferential payments were given in exchange for a simultaneous or near simultaneous rendering of services or delivery of goods, the most common of which would be the COD purchase.18 Such simultaneous exchanges would also apply to prepayments for merchandise released upon receipt of payment. The theory here is that there was no antecedent debt and that the estate received an equivalent exchange of value for the alleged preferential payment.

Defense #3: Payments for subsequent new value. The third affirmative defense to a preference action is that the creditor provided subsequent new value after receiving the alleged preferential payment.19 To establish this defense, the creditor must show that it rendered services or delivered merchandise after receiving the alleged preferential payment and that it has not received payment for those goods and services.

This defense is not proved merely by presenting your client's ledger of unpaid invoices rendered during the 90 days immediately preceding the bankruptcy. The creditor must show the invoices were delivered to the debtor after the creditor received each alleged preferential payment the trustee seeks to avoid.

Ethical considerations

Bankruptcy Rule 9011 requires that an attorney who affixes his name to a complaint perform sufficient due diligence to establish that the claim is bona fide. As has been indicated, attorneys for debtors often are retained to prose¬cute these preference actions just before the two-year statute of limitations expires, and thus these cases may be rushed into suit. While on the face of the statute an attorney can bring a preference action by merely referring to the bankrupt's payment ledger, the seventh circuit court of appeals has declined to rule "that courts can never impose Rule 9011 sanctions for counsel's failure to investigate an affirmative defense."20

In other words, it is not clear that trustee's counsel can get away scot-free with the argument that he has made a prima facie case, and now the creditor is left with the burden to prove its affirmative defense. In the Matter of Excelo Press,21 the attorney for the trustee only escaped sanctions by arguing that he needed discovery to establish the ordinary course of business in the creditor's industry.

Under the BAPCPA, this is not a defense. Moreover, if the trustee knew, or should have known, that the alleged preferential payments made within 90 days of the filing of the bankruptcy were no different in interval from those payments between the parties made prior to the preference period, there could be exposure under Bankruptcy Rule 9011.

Creditor-friendly limits on small cases

The BAPCPA provides that the trustee may not bring an action to avoid a transfer of an alleged preferential payment against a commercial creditor in cases where "the aggregate value of all property that constitutes or is affected by such transfer is less than $5,000"22 and further provides that the venue for filing of any action for less than $10,000 is in the district in which the defendant resides, in commercial (non consumer) cases.23

No longer will the trustee be able to bludgeon a hapless creditor in some remote part of the United States to settle an alleged preference action where the amount involved is under $5,000, and he will certainly think twice before hiring an attorney to pursue an action in the district where the creditor resides in cases up to $10,000 in commercial (non consumer) cases.

Preference actions: not going away

Although the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 provides relief to creditors in smaller cases up to $10,000, it is unlikely that the trustee will lose interest in pursuing larger preference cases. It is far too easy for the trustee to make a prima facie case, and there is tremendous economy in mass filings in larger cases where service can be affected by U.S. mail. Further, given the role of collection agencies and non-lawyers in pre-filing collection efforts and the availability of consultants who can analyze the bankrupt's records prior to filing, preference actions are likely to remain an attractive alternative for the bankrupt's estate.

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