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Preferences And How To Avoid Them In Both Bankruptcy And State Court Venues

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Credit managers and accounts payable departments are often faced with concerns surrounding faltering business customers. Both the Bankruptcy Code and state court laws contain provisions dealing with payments and other considerations made during the last several months prior to instituting insolvency proceedings. If you are the recipient of payments during that period which is 90 days under the Bankruptcy Code, you may have to return the payment or at least a part of it depending on the circumstances. The purpose of the Code provision dealing with preferences is twofold. It is designed to promote equality of distribution among all creditors while simultaneously it deters creditors from racing to the courthouse to dismember the debtor during its slide into bankruptcy.

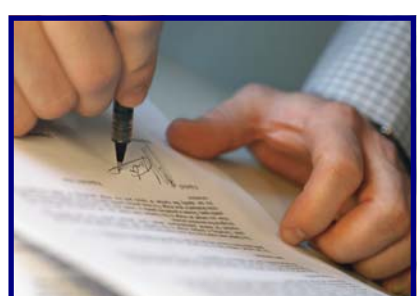
Given these concerns bankruptcy trustees or debtors-in-possession are permitted to avoid certain preferential transfers made to creditors in the 90-day period immediately preceding the filing of a bankruptcy petition. Section 547 of the Bankruptcy Code lists five elements that up a preferential transfer. First, the transfer must be to or for the benefit of a creditor. Second, the transfer must relate to an antecedent debt owed before the transfer. Third, the transfer must have been made while the debtor was insolvent. Fourth, the transfer must have occurred within 90 days prior to the filing of the bankruptcy petition (or one year in the case of the creditor/transferee being an insider of the debtor). Fifth, the transfer must enable the creditor to receive more than such creditor would have received in a Chapter 7 liquidation if the transfer had not been made.

Payments to fully secured creditors during the preferential period are not considered preferences for the reason that such payments to a fully secured creditor do not deplete the debtor's bankruptcy estate. Payment to an unsecured creditor or an undersecured creditor on the other hand almost always satisfies the fifth element. The overall goal of the preference law in the Bankruptcy Code is to avoid depletion of the debtor's bankruptcy estate prior to the bankruptcy filing. If it can be shown that there is no depletion such that other creditors similarly situated obtain a lesser recovery on their claims due to such payment, courts are more likely to determine that either no preferential transfer occurred or that such preferential transfer is permitted if the Code's exceptions apply.

Oftentimes the trustee or the debtor-in-possession will send a letter to you describing the payment the debtor made to you during the 90-day period and contend that it constitutes a preference. The letter will then make demand upon you to pay the preference within so many days in order to avoid litigation. In some instances the letter will offer a discount if the letter is complied with. Many of these exceptions. Since most of the exceptions are designed to encourage creditors to continue dealing with the faltering company the most commonly invoked exception is generally known as the "ordinary course of business" exception or the "new value" exception.

Under the ordinary course of business exception the Code is encouraging normal business relationships which favor creditors who work with faltering businesses. The "ordinary course" defense usually arises where the trustee or debtor-in-possession seeks to avoid a payment to a trade vendor who routinely provides the debtor with goods and services used in the course of the debtor's business. To succeed, the creditor who received the preferential payment must prove that the payment arose in the ordinary course of the debtor's business. This is a subjective test where the court evaluates whether the course of dealing between the debtor and the creditor indicates that the transfer was not unusual.

The creditor must prove that past practices between it and the debtor continued while the alleged preferential transfers were made. Other elements that the court must decide are whether the amount, the form, the timing, the method of collection or any other characteristics of the transfer is different from past transfers. It usually boils



transfer when compared with the due date is consistent with the timing of prior payments by the same debtor to the creditor so that if the creditor's terms are 30 days the preferential payment was made within such period. The foregoing holds true as well where the creditor historically accepted late payments from the debtor for the reason that such payment is still within the bounds of the past billing and payment practices between the debtor and the creditor. If the creditor changes the payment procedures, the exception may not apply as being out of character with the long history of payments between them. Examples of such action are sending collection letters, requiring payment by wire transfer, forcing it to make large, unusual payments or reducing its credit limits. If the creditor cannot meet the subjective test, it has the option of using the objective test where the court looks to industry standards to determine whether the transfer was normal or not. For this exception to apply expert testimony is usually required.

A second exception is the "new value" exception. This exception generally prevents the trustee or debtor-in-possession from avoiding the transfer when the transfer was made in exchange for something that increases or at least does not deplete the debtor's assets. The usual example is when the debtor pays the creditors for goods and services contemporaneously with the supply of new goods and services. The exchange need only be "substantially contemporaneous." The exception may also apply under the "subsequent new value" exception. A creditor's liability for a preferential transfer may be offset giving the debtor new value usually in the form of goods and services subsequent to the contested payment. If after receiving payment the creditor subsequently provides more goods to the customer on credit, the value of the newly shipped goods can be used to set off dollar for dollar its liability on the previous preferential payment. If the creditor is paid for such shipment prior to bankruptcy, the exception does not apply. This exception is based upon the argument that the new value replenishes the estate. However if such new shipment is paid, the exception does not apply. The important thing is that the new shipment be subsequent to the receipt of the preferential transfer. Creditors cannot aggregate the value of goods and services it provided during the preference period and offset this value directly against amounts of preferential transfers it has received.

Lastly, if the preferential payment is made to an insider which includes the debtor's corporate officers, their family members, general partners and corporate affiliates, such transfers are subject to a look-back period for one year rather than the standard 90 days. However the insolvency presumption only applies to the 90-day period.

Most states likewise have a preferential transfer rule. In Wisconsin Chapter 128 of the Wisconsin Statutes includes a preferential transfer section. The Wisconsin law was enacted back in 1937 and the language is drawn from provisions of the Bankruptcy Act of 1898. These provisions came from the Bankruptcy Act which was subsequently repealed and completely replaced by the Bankruptcy Code. Therefore the Wisconsin preference statute is substantially different from the Bankruptcy Code. To begin with, the preferential period is four months rather than 90 days. There is no presumption that the debtor was insolvent during the preferential period and thus insolvency must be proved by the court appointed receiver. The receiver must prove that the recipient of the transfer had reasonable cause to believe that the transfer received would effect a preference. The Wisconsin law further contains few exceptions but does include the new value exception.

In Wisconsin receiverships creditors often receive letters from the receiver similar to the letters trustees send out in federal bankruptcy cases. In many instances the receiver will have a very difficult task proving the requirement in Wisconsin Statute that the recipient had reasonable cause to believe that the transfer would effect a preference. Therefore such letters and similar letters from bankruptcy trustees should be reviewed by your counsel.

In both the bankruptcy court and the state court receivership proceedings the trustee or the receiver must bring a separate action in order to recover the preferential payment. In many such situations the claim can be settled for much less than the amount of the transfer.

The key to avoiding preferential transfer claims is to keep good records so that you can successfully defend against such claims.

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