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Keeping the Money: Strategies for Protecting Against Preference Liability

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Creditors doing business with entities they suspect are on the verge of filing for bankruptcy protection need to be aware that they may be required to return the payments received from that entity within the 90 days preceding a bankruptcy filing. Whether you are a party to litigation entering into a settlement agreement, a trade creditor contemplating a compromise of a delinquent account, a lender negotiating a workout, or simply conducting business as usual, all dealings with financially troubled parties should be approached with an eye on avoiding preference risk.

As a preliminary matter, although most creditors would likely consider it unreasonable that they be required to return a payment received on a valid debt, the preference provisions are intended to ensure all creditors receive an equitable pro rata share of the debtor's assets. Despite the idealistic purpose of the Bankruptcy Code's preference provisions, there is nothing improper about accepting an avoidable preferential payment. As a result, all creditors should be aware of the following defenses and practical strategies for reducing potential liability to preference claims.

Elements of a Preference Action

Section 547 of the Bankruptcy Code sets forth the required elements that a trustee, or debtor in possession, must successfully establish to recover a preferential payment. The trustee bears the burden of proof in establishing that the payment was (i) a transfer of an interest of the debtor in property, (ii) made to or for the benefit of a creditor, (iii) for or on account of an antecedent debt, (iv) made while the debtor was insolvent, (v) made within 90 days before the date of the bankruptcy filing (or within one year if the creditor is an insider of the debtor) and (vi) that resulted in the creditor receiving a greater distribution than it otherwise would have in a chapter 7 distribution.

Preference liability is predicated upon a creditor's betterment of position during the ninety days preceding a bankruptcy filing. As a result, fully secured creditors (those with collateral of a value in excess of the debt) typically do not need to be concerned about preference risk because pre-petition payments do not provide secured creditors with a greater distribution than they would receive upon liquidation of the collateral. However, under-secured creditors (those with collateral of a value less than the amount of the debt) and unsecured creditors do need to be aware of preference risks because pre-petition payments within the preference period will improve those parties's distribution upon liquidation. Likewise, the grant or perfection of a new security interest within the preference period, such as the acquisition of additional security through a workout, is also subject to potential avoidance.

Statutory Defenses

The Bankruptcy Code provides several defenses to preference liability in order to encourage creditors to continue conducting business with a financially troubled debtor in the hope of avoiding a bankruptcy filing. The three most common defenses are (i) the contemporaneous exchange for new value, (ii) the subsequent new value and (iii) the ordinary course of business defenses.

The first of these three defenses prevents recovery of a payment when the transfer was intended by the debtor and creditor to be a contemporaneous exchange for new value given to the debtor and when such exchange was in fact substantially contemporaneous. New value is defined by the bankruptcy code as money or money's worth in goods, services, or new credit, or a release by a transferee of property previously transferred, but does not include an obligation substituted for an existing obligation.

A common mistake of creditors conducting business with a financially distressed entity is to apply incoming payments to the oldest outstanding invoices. Creditors who suspect a debtor is in financial trouble and wish to protect incoming payments from a preference action should apply those new payments to the goods or services provided at the time of payment. Doing so will allow a creditor to avail itself of the contemporaneous exchange for new value defense.

Slightly different is the subsequent new value defense which, as the name suggests, prohibits a trustee from avoiding a transfer where the creditor subsequently provided new value to the debtor. After learning of a debtor's a bankruptcy filing, a creditor should account for all payments received within the 90 days preceding the filing and match those payments to goods shipped or services provided after the date of the oldest payment received within the preference period. This will allow the creditor to analyze the extent of its new value defense and

potential liability to a preference attack, aiding in a cost-effective resolution of any preference demand.

The third of the common defenses is the ordinary course of business defense. It applies when the payment is received in the ordinary course of business between the creditor and debtor. The 2005 revisions to the Bankruptcy Code greatly eased the requirements for application of this defense in that a creditor now must prove either that the payment was received in the ordinary course of business between the parties, or on terms ordinary for their particular industry.

To successfully employ this defense it is imperative a creditor maintain detailed records of the dates that payments are received in relation to the dates invoices are generated in order to show that the pattern of payments received within the 90 day preference period is comparable to either industry statistics or the prior payment history between the parties. This defense highlights another common mistake of creditors, which is to restrict credit terms upon discovering a debtor is experiencing financial difficulty. Several courts have found that payments received after a creditor began restricting credit terms were not made within the ordinary course of business between the creditor and debtor. Rather than tighten or more strictly enforce credit terms, creditors should require prepayment in order to avail themselves of the new value defenses discussed above.

Settlements and Workouts

The majority position among the courts is that a settlement payment constitutes a preference because the parties are compromising an antecedent debt and no new value is being provided to the debtor. However, a minority of courts have agreed with the argument that a settlement agreement constitutes a contemporaneous exchange for new value when the settlement releases the debtor from risk of a contingent claim, thus providing the debtor with new value. Therefore, when entering a settlement agreement, the agreement should be drafted in such a way that it may be viewed as an exchange for new value. This can be accomplished by (i) reciting the new value being exchanged, such as a full release of all causes of action, and (ii) reciting the parties' intentions that the exchange be substantially contemporaneous. Further, when possible the parties' intentions should be included in a court order approving the settlement agreement.

Another possibility for drafting a transaction that minimizes risk of avoidance is to make use of the earmarking doctrine. One of the elements necessary for a trustee to avoid a pre-petition transfer is the requirement that the transfer consist of an interest of the debtor in property. This requirement presents an opportunity for structuring a transaction in a way that limits the risk of a preference attack. The earmarking doctrine protects transfers that are supplied by and earmarked for the creditor by a non-debtor third party, such as a new lender, an insider or an affiliate. If a creditor can establish that all of the elements of the earmarking doctrine have been met, it may be able to successfully protect a settlement payment received within the 90 days preceding the debtor's bankruptcy filing from avoidance as a preference.

Conclusion

Although it may be impossible to completely eliminate all preference risk when dealing with a distressed entity, especially when drafting a settlement or workout agreement, the strategies discussed herein can help reduce such risk. Further, given the available statutory defenses, if a payment received within the preference period is attacked as a preference, a compromise can likely be reached with the trustee that would prove more favorable to the creditor than the recovery that could be expected through the bankruptcy claims process.

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