PREFERENCE LAW

by Randy Nussbaum

I. INTRODUCTION

The vast majority of preference law is unique to the Bankruptcy Code. Though in certain instances an aggrieved creditor can bring a claim under state law when that creditor's debtor prioritizes payments to third parties, the ability to do so is very difficult and subject to relatively strict statutory and judicial parameters. On the other hand, recovering preferential payments in bankruptcy is far easier than under state law because the Bankruptcy Code provides specific statutory authority to recover such payments. Preferential payments are recoverable in bankruptcy court because of the legislative desire that creditors in the same class be treated equally. In principle, this legislative desire is commendable and should prevent a debtor from "gaming" the system by paying off preferred creditors. Simultaneously it ensures that creditors who are willing to work with the debtor are not unfairly penalized by their cooperation. Understandably, from the perspective of a defendant facing a preference claim, this statutory power can be extremely frustrating.

The pertinent statute is 11 U.S.C. § 547. In simplest terms, a payment made on account of an antecedent debt by the debtor within 90 days of bankruptcy is recoverable by the bankruptcy trustee or, in the case of a Chapter 11, by the debtor-in-possession. When the payment is made to an insider, because of the basic premise that an insider is fully aware of the debtor's financial condition, the payment is recoverable if made within one year of the bankruptcy filing. On its face, all of this is rather straightforward, but further review quickly demonstrates that it is not.

Section 547 applies in all forms of bankruptcy, be it Chapter 7, 11, or 13[*]. Nevertheless, there are some practical differences in how preference claims are pursued depending upon the bankruptcy Chapter.

II. APPLICATION IN CHAPTER 7, 11, AND 13 CASES

In a Chapter 7 case, an independent trustee is assigned to administer the bankruptcy estate, and that trustee, normally through counsel, is charged with the responsibility of recovering any preferential payments. Though the Chapter 7 debtor is obligated to provide the trustee with the relevant disclosure regarding such payments, once that information is disseminated to the Chapter 7 trustee, it is the trustee's sole responsibility to pursue the claim. A Chapter 7 trustee is compensated based on a percentage of the amount of assets distributed to creditors.

In a Chapter 13 case, similar to a Chapter 7 case, the assigned trustee is also responsible for pursuing the preference claim. However, an important distinction is that Chapter 13 trustees do not have the same incentive to pursue preference claims because they are paid a percentage of what the Chapter 13 debtor pays through the Plan of Reorganization. The recovery of a preference could in many instances result in an increased dividend to unsecured creditors and therefore more money

[*] This outline will not address the relatively rarely used Chapter 9 or 12.

for the trustee, but Chapter 13 trustees simply don't have the incentive or necessarily the inclination to devote substantial attention to such recoveries.

As a result, it has been my experience that Chapter 13 trustees are less inclined to pursue such a recovery, and in many instances, if the Chapter 13 debtor is willing to voluntarily incorporate into the Plan payment in an amount sufficient to cover a significant portion of the preferential payment, the matter will not be pursued.

This is not to suggest that a Chapter 13 trustee will not try to recover a significant preferential payment that was made by a Chapter 13 debtor, but a quick review of the bankruptcy docket and published opinions will confirm that Chapter 13 trustees normally are not participants in litigation of this type.

In a Chapter 11, the debtor-in-possession has the statutory powers of a trustee and has the absolute obligation to creditors to recover any such amounts. In most cases, the debtor-in-possession will do so. Since the settlements are subject to Court approval, the ultimate disposition must be in the best interests of the bankruptcy estate and the creditors. In some Chapter 11 cases, the confirmed Plan will provide for an independent liquidating trust to recover such amounts. In many instances this makes sense because the debtor-in-possession is focusing on other aspects of the Chapter 11 and may not be the appropriate party to pursue any such recoveries.

In certain instances, the Chapter 11 case does not justify the appointment of a separate entity to pursue the preferences and the debtor refuses to do so. In these cases, the debtor's inaction constitutes grounds for conversion, dismissal, or even the appointment of a Chapter 11 trustee to step in.

III. HOW PREFERENCES ARE PURSUED

Pursuing the recovery of a preferential payment requires the filing of a separate adversary proceeding. The trustee has the later of two years from the petition date or one year from the date of his/her appointment to bring the adversary complaint. In converted cases where the trustee is appointed in the second year, the trustee still has one year from being appointed to bring the adversary.

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 placed restrictions on when and where a debtor can pursue preferences. In a business case, the claim cannot be pursued unless the amount involved is at least $6852 and when the claim is less than $25,000, the action must be brought in the district in which the defendant resides. These specific changes were implemented, correctly, because, in multi-preference litigation cases, preference defendants would many times write nuisance value settlement checks because they could not afford the cost of defense or to travel to the district in which the action was brought. Since legal fees are not recoverable in preference litigation except in rare instances under a Rule 11 violation, limiting where preference litigation could be brought was the best solution to a rather inequitable situation.

IV. HOW TO DEFEND A PREFERENCE CLAIM

Certain payments made on account of an antecedent debt are not preferences based on Section 547(c). However, for purposes of this discussion, any position that could be advanced to defeat a preference claim will be identified as a defense.

A. Insider versus non-insider

What constitutes an insider is determined both by referring to the statutory definition of an insider found in Bankruptcy Code Section 101 (31) and through case law. It is up to judicial determinations as to when a potential defendant possesses all the requisite characteristics to still be an insider even though not specifically identified under the statute.

The vast majority of the controversy revolves around non-statutory insiders for the obvious reason that it is relatively easy and straightforward to identify who or what falls within the purview of the statutory definition.

Defendants who have been determined to be insiders even though their volition falls outside the statutory definition include:

- Both company that was spun off from debtor and company's owner, a friend of the debtor's principal, were found to be non-statutory insiders. *In re Bruno Machinery Corp.*, 435 B.R. 819 (Bankr. N.D. N.Y. 2010).

- Corporation wholly owned by Chapter 7 debtor's father was non-statutory insider based on lack of arm's length transactions. *In re Smith*, 535 B.R. 374 (Bankr. D. Colo. 2015).Long-time accountants that assisted corporate debtor's management in concealing debtor's insolvency, thereby allowing debtor's insolvency to deepen, exercised sufficient control over debtor to qualify as non-statutory insiders. *In re TS Employment, Inc.*, 603 B.R. 700, 703 (Bankr. S.D.N.Y. 2019).

No hard and fast rules exist to differentiate an insider from a non-insider outside of the statutory definition. This of course makes sense when you use an example of an ex-spouse since certain ex-spouses would constitute an unequivocal non-insider, whereas other ex-spouses could very well possess certain knowledge and information which in certain instances elevates them to a party having far more "insider" information than even most statutory insiders. Whether a transferee is considered a non-statutory insider depends on the closeness of the relationship with the debtor and whether the transaction is truly arms-length. *In re The Village at Lakeridge, LLC*, 814 F.3d 993 (9th Cir. 2016).

B. Contemporaneous Exchange for New Value

A potential debtor who engages in a contemporaneous exchange even the day before bankruptcy is not engaging in the type of activity that the Bankruptcy Code is designed to discourage and to rectify under preference law. If a third party is providing a contemporaneous exchange for new value equivalent to the payment being made by the debtor, this conduct is not offensive in any manner and is not prioritizing one creditor over another. The purpose of the contemporaneous exchange for new value defense is to encourage creditors to continue to deal with financially distressed debtors as long as their transactions involve true exchanges of equally valued consideration. Of course, this leaves to be determined what is a contemporaneous exchange. The critical inquiry in determining whether there has been a contemporaneous exchange for new value is whether the parties intended such an exchange. *In re Wadsworth Bldg. Components, Inc.*, 711 F.2d 122, 124 (9th Cir.1983). The following are examples of what are considered to be contemporaneous exchanges.

- Fourteen-day delay in perfection was a substantially contemporaneous exchange, so long as the delay can be satisfactorily explained. *In re Marino*, 193 B.R. 907 (9th Cir. B.A.P. 1996), aff'd 117 F.3d 1425 (9th Cir. 1997).

- Payments to subcontractors from general contractors. *In re JWJ Contracting Co., Inc.*, 287 B.R. 501 (9th Cir. B.A.P. 2002).

Rents paid a few days after the first of the month are contemporaneous exchange for new value for purposes of exception to trustee's avoidance powers since statute requires only that payments be "substantially contemporaneous." *In re Garrett Tool & Engineering, Inc.*, 273 B.R. 123 (E.D. Mich. 2002).

- Additional labor, equipment, and materials that subcontractor provided, on unsecured basis, after receiving payment from general contractor debtor was in nature of contemporaneous exchange for new value. *In re Modtech Holdings, Inc.*, 503 B.R. 737, 751 (Bankr. C.D. Cal. 2013).

- Late rent which Chapter 7 debtor paid to its commercial landlord, in same month that rent was due (28 days late), was in fact substantially contemporaneous with new value that lessor provided in allowing debtor to occupy premises. *In re JS & RB, Inc.,* 446 B.R. 350 (Bankr. W.D. Mo. 2011).

C. Ordinary Course Payments

The law has evolved over the years in favor of the preference defendant. Currently, a defendant can either argue that the payments made by the debtor were in the ordinary course pursuant to industry standards or the payment was within the ordinary course based upon the past dealings between the debtor and the payment recipient. Without question, allowing either of these defenses to defeat a preference claim shows that a creditor is not at risk of receiving a pre-bankruptcy payment if the payment is consistent with what that party had been receiving over an extended period or was within industry standards. Not surprisingly, both the prior course of business defense and the consistency with industry standards defense are regularly litigated.

For example, if the debtor ordinarily paid the creditor 20 days from the billing, but the industry standard is that the payment would be made within 30 days and the debtor then makes a payment to the creditor 38 days after the billing, would this payment be preferential? A review of the case law does not provide specific guidance, though as a general proposition, the Bankruptcy

Court is normally trying to ascertain whether the payment really was preferring one creditor over the others and whether the payment is inconsistent with the general course of dealings between the parties over an extended period or what is normal in the industry.

D. Subsequent New Value

It is not unusual in many instances for a debtor making a large payment on account of even past due debts to convince the third-party creditor to extend additional credit to the debtor in the form of services or product. When that occurs, because it is inherently unfair for that creditor to then not get paid for the new value extended while having to return what may have been paid within the preference period, the Bankruptcy Code normally allows a creditor to set off the amount of new credit extended after the preferential payment for equitable reasons. As a practical matter, in such instances, the creditor is not receiving any type of benefit because if the creditor receives $20,000 on account of an antecedent debt right before bankruptcy and then extends $20,000 of credit to the debtor shortly thereafter, the creditor is out the same $20,000 that it would have been if it had never received the preferential payment.

E. Debtor was Solvent

If you can prove the debtor was solvent when the payment was made, the payment would not be a preference.

F. Preference Standard Under the Small Business Reorganization Act (SBRA)

Under SBRA, the trustee can only pursue such a claim

> …based on reasonable due diligence in the circumstances of the case and taking into account a party's known or reasonably knowable affirmative defenses under (c)….

V. UNUSUAL ISSUES IN PREFERENCE LITIGATION

A. The Danger of Involuntary Cases

For reasons that are not totally clear, often little attention is paid to the impact on a creditor pursuing an involuntary debtor when that creditor has received payments on account by the debtor. This may be the result of involuntary cases rarely being brought or simply an ignored topic. Nevertheless, it's definitely worth considering.

Normally, an involuntary petition is filed in that rare instance in which the petitioning creditor or creditors have determined that the debtor is insolvent and is disposing of its assets. If an involuntary petition is granted, then a trustee is appointed to administer the bankruptcy estate and the offensive payments come to a grinding halt. Once the monetarily irresponsible party is in bankruptcy, the petitioning creditors can then participate in whatever is available in the estate.

A petitioning creditor needs to conduct proper due diligence before ever participating in an involuntary filing. Such an action should never be brought unless the petitioning creditor engages in an in-depth analysis of all payments that may have been received within 90 days of the involuntary bankruptcy filing. Determining whether an involuntary bankruptcy would be beneficial to the creditor or creditors requires a complex calculation as to what that creditor may have to relinquish in return for what that creditor may ultimately receive. If a creditor's exposure on preferential payments is a nominal amount of a few thousand dollars, but its overall claim is half a million dollars, deciding whether to bring an involuntary bankruptcy is probably relatively easy. In instances in which hundreds of thousands of dollars may have flowed to the petitioning creditor within 90 days of bankruptcy, that creditor must engage in a mathematical calculation, while also utilizing clairvoyant powers to determine whether it is better having to return a certain amount already in its pocket versus an indefinite recovery in the bankruptcy case.

B. Domestic Relations Claim

The Bankruptcy Code, Section 547(c)(7), provides that a debtor's domestic support obligations are not preferential. The broad scope of the pertinent statute can lead to certain gamesmanship by friendly husbands and wives who are divorcing, but also trying to maximize bankruptcy exemption planning. For example, if a husband writes a check to his ex-wife for $50,000 right before he files for bankruptcy protection because he needs to pay a priority and non-dischargeable debt and he wants to make sure his trustee doesn't grab that money, are there any circumstances in which such a payment can be reversed? The case law is fairly vague in this area, though in those rare instances in which the court concludes that the payment was only made for improper purposes, the payment was successfully challenged. See the following cases:

- § 547(c)(7) does not apply to exclude avoidance of debtor's payment of residence expenses such as a mortgage, taxes, insurance, improvements, repairs, and maintenance where divorce did not specifically obligate ex-spouse to make those payments. *In re Raynor*, 2008 WL 2487867, at *3 (Bkrtcy.D.Neb.,2008)

- SNAP benefits that Chapter 7 debtor received prepetition qualify as support of debtor's children, but debtor's obligation to the state for overpayment of such benefits did not retain its character as support obligation, and state could collect since overpayment excepted from avoidance under § 547(c)(7). *In re Halbert*, 576 B.R. 586 (Bankr. N.D. Ill. 2017).
- The attorney's fees incurred by debtor's former spouse in protecting her child support award were nondischargeable as a domestic support obligation under § 547(c)(7) and therefore not collectable. *In re Johnson*, 445 B.R. 50 (Bankr. D. Mass. 2011), amended in part, No. 09-19214-JNF, 2011 WL 1467913 (Bankr. D. Mass. Apr. 18, 2011).

C. Tax Claims

Debtors facing non-dischargeable tax claims who may have available funds to pay them don't want to see those payments reversed. However, in certain instances, the debtor cannot wait to file for bankruptcy and therefore has to do so in the face of such payment. Unlike the provision regarding domestic relations orders, the preference exception for tax payments was not enacted.

If the debtor can't wait more than 90 days before filing for bankruptcy, the debtor should not make such a payment unless the payment is also entitled to priority. If it is, then since it would normally be paid in advance of all other creditors, some trustees will not bother to try to seek recovery of the amount. However, the case law is not totally clear, and some decisions allow such a recovery, while others do not, depending on the specific amounts involved and whether the money that may be recovered from the taxing authority may have to be shared with other priority creditors or for administrative purposes.

Although there is no preference defense for tax payments, Section 547(a)(4) does provide some guidance. That Section provides that for the preference purposes "a debt for a tax is incurred on the day when such tax is last payable without penalty, including any extension." Simply put, this definition guides as to when a tax debt qualifies as an antecedent debt for purposes of a preference action.

D. When is the Payment Actually Made?

Actual money rarely changes hands anymore in today's society. Therefore, it can be complicated and confusing to determine exactly when the recipient actually receives the payment. Because preference law is absolute in that a payment that is received 90 days and one minute from when the debtor files for bankruptcy is not a preference, but a payment received one minute within the 90 days is a preference. Determining when the money is actually in the third-party creditor's hands is crucial.

The Court looks at the ninetieth (90th) full day in determining whether the payment was received within 90 days of the bankruptcy filing. In simplest terms, if the debtor files first thing in the morning and the payment is received by the recipient at 11:59 on the ninetieth day, even though technically more than 90 days may have passed from the time of the filing until the receipt of the payment, the payment is still preferential. On the other hand, if the recipient shows that the actual payment was received in the recipient's account at 12:01 a.m. on the ninety-first day, the payment is not preferential.

E. Collectability Issues

In many cases, the recipient of the alleged preferential payment received the payment because it was applying pressure on the debtor due to economic necessity or because the debtor recognized that the creditor could not withstand the loss of the payment. From the onset, a party pursuing a preference claim has to devote substantial attention to this analysis because if the recipient truly has limited resources, no public purpose is served by either putting that entity out of business or forcing it into bankruptcy.

VI. DEBTOR'S STRATEGIES

A. When Preference Recoveries can be Detrimental to a Debtor

In most situations, a bankruptcy debtor either is unconcerned about a preference recovery or will benefit from it. But there are situations in which a debtor would want to avoid filing for bankruptcy to prevent a preferential payment from being recovered. Recognizing those instances in which a debtor should delay the filing can be very advantageous for the debtor.

The debtor may be dealing with a friendly creditor which the debtor doesn't want to see facing a preference recovery. The debtor may have a long-term relationship with that creditor and either doesn't want to see that creditor hurt or wants to continue that relationship. Creating aggravation and monetary loss for that creditor may cost the debtor a strong relationship it does not want to lose.

Occasionally, with an individual Chapter 7 debtor, a recovery of a preferential payment may trigger a non-dischargeability Complaint under Section 523 either because of excessive credit card use, for fraud, or willful and malicious conduct. By paying a creditor who possesses such a claim, the debtor would normally eliminate such a claim being brought, but if the payment is then reversed as being preferential, the creditor may then be motivated to bring an adversary. Of course, all of this can be avoided if the payment is determined to not be preferential. Obviously, when a creditor possesses a non-dischargeable claim, the debtor doesn't ever want to see such payments reversed.

B. Benefits of Preferential Recoveries

Oftentimes in a reorganization case, the debtor is desperately in need of cash. In situations in which the payment is clearly preferential and the defendant is willing to settle quickly, recovering this money can help fund a reorganization. Those monies could be earmarked for desperately needed administrative expenses or eventually used to pay priority claims. In instances in which the recovered monies were used to pay taxes which otherwise could be assessable against the principals of a Chapter 11 debtor, timing the bankruptcy to ensure maximum recovery is a crucial and very helpful strategy.

VII. CONCLUSION

A bankruptcy debtor needs to understand the ins and outs of preference law to ensure that any such recovery will not cause undue hardship to the debtor and in other instances may actually be of assistance to it. A creditor who may be facing a preference claim needs to understand its potential defenses and in certain instances, even encourage a potential bankruptcy candidate to delay filing if doing so avoids the preference claim in cases in which the debtor would benefit as well from that outcome.