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Can Sanctions Be Imposed For Improperly Prosecuted Preference Actions?

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Introduction

Preference lawsuits are a constant source of anguish in the credit community. But there is nothing more gratifying than winning a preference lawsuit and depriving a bankruptcy trustee or debtor-in-possession of any recovery on the claim.

However, victory usually comes at a high price! A successful creditor/preference defendant frequently must incur significant legal and other costs to obtain dismissal of a preference action. And according to the American rule, in the absence of state law or a contractual provision to the contrary, a successful party in a lawsuit is usually not entitled to reimbursement of its legal and other costs incurred in connection with the litigation.

In the face of this stark reality, a senior credit executive recently asked whether a trustee or other preference plaintiff has an obligation to investigate and take a creditor's defenses into account in considering whether to prosecute a preference action? Are there any circumstances where a creditor, that successfully defends and obtains dismissal of a preference lawsuit, has a claim for sanctions

against the plaintiff and its counsel for improperly prosecuting a losing case?

The issue of a successful preference defendant's right to recovery of sanctions from a trustee or other preference plaintiff and/or its counsel was recently considered by Bankruptcy Judge Jerome Feller, in *In re Berger Industries, Inc.*, a bankruptcy case pending in the United States Bankruptcy Court for the Eastern District of New York. Following the bankruptcy court's dismissal of a protracted and bitterly contested preference action, the successful preference defendant, a trade creditor of the debtor, had moved against the debtor's counsel for reimbursement of the creditor's legal costs incurred in defense of the litigation. The creditor based its sanctions claim on the failure of Berger's attorney to investigate the ordinary course of business defense the creditor had asserted and relied upon in winning the lawsuit. While the bankruptcy court had refused to impose sanctions against Berger's counsel, the court rejected a *per se* rule that would have negated any requirement for a preference plaintiff and its counsel to conduct a pre-lawsuit investigation of affirmative defenses to a preference claim. The court imposed a duty on a bankruptcy trustee

or debtor-in-possession to investigate "obvious" affirmative defenses prior to commencing a preference action, though found that the ordinary course defense successfully asserted by the creditor was not a basis for sanctions because it was factually complex and not "obvious" when suit was filed.

The decision serves as a warning to bankruptcy trustees and other preference plaintiffs that under the right egregious circumstances, a victorious preference defendant might recover sanctions from the losing party based on the prosecution of a non-sustainable preference lawsuit.

An Overview of Preference Claims and Defenses

Section 547 of the Bankruptcy Code governs preference claims and defenses. The preference statute is designed to discourage a debtor from preferring one creditor over other creditors by opting to pay a creditor, but not other creditors, during the debtor's slide into bankruptcy. This is supposed to ensure that all of the debtor's creditors are treated fairly, and thereby discourage creditor enforcement actions that might precipitously and prematurely force a debtor into bankruptcy.

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A bankruptcy trustee or other preference plaintiff can avoid and recover transfers as preferences for the benefit of all creditors and the debtor's bankruptcy estate by proving all of the following: (1) the debtor transferred its property to or for the benefit of a creditor; (2) the transfer was made on account of antecedent indebtedness owing by the debtor to that creditor; (3) the transfer was made within 90 days of the commencement of the bankruptcy case for non-insider creditors; (4) the debtor was insolvent at the time of the transfer (i.e., liabilities exceeded assets, which is presumed within the 90-day preference period); and (5) the transfer enabled the creditor to receive more than it would have received had the transfer not been made and the debtor was liquidated under Chapter 7 of the Bankruptcy Code.

Once a trustee or other preference plaintiff proves all of the Section 547(b) elements of a preference claim, a creditor/preference defendant can seek to reduce its preference exposure by satisfying the requirements of one or more of the defenses to preference claims contained in Section 547(c). Section 547(c)(1) excuses from preference recovery any payment or other transfer that the debtor and creditor had intended as a contemporaneous exchange for new value and that was, in fact, a substantially contemporaneous exchange. This defense is frequently invoked for cash on delivery (COD) payments.

Another typical preference defense is the new value defense arising under Section 547(c)(4). The new value defense allows a creditor to reduce a preference claim by the creditor's extensions of credit to or for the benefit of the debtor subsequent to any alleged preferential transfer. The new value cannot be secured by an otherwise unavoidable security interest and cannot be paid by an otherwise avoidable transfer.

The ordinary course of business defense arising under Section 547(c)(2) is another frequently raised preference defense. A transfer is not a preference if it was (A) in

payment of a debt incurred by a debtor in the ordinary course of business or financial affairs of the debtor and the creditor; (B) made in the ordinary course of business or financial affairs of the debtor and the creditor; and (C) made according to ordinary business terms. The first requirement, the incurrence of debt in the ordinary course, is straightforward and usually satisfied by a creditor's extension of credit to the debtor. The second requirement, payment in the ordinary course of business, requires a comparison of, and consistency between, the alleged preference payment and the payment history between the debtor and creditor. The third requirement, payment according to ordinary business terms, requires a showing that the alleged preference was consistent with the payment practices in the relevant industry, and was not "idiosyncratic" or "unusual" when compared to payments to others in that industry.

Each of these defenses, and the other preference defenses contained in Section 547(c), are intended to encourage creditors to continue doing business with, and extending credit to, financially distressed firms. The contemporaneous exchange (COD) and new value defenses are based on a creditor's providing new goods or services to or for the benefit of a financially distressed debtor that replenishes the debtor, either after the transfer in the case of the new value defense, or substantially contemporaneously with the transfer, in the case of the contemporaneous exchange defense. The new value and ordinary course of business defenses are also intended to encourage creditors to continue doing business on normal credit terms with a troubled company. In the absence of these defenses, creditors would not have any incentive to continue dealing with, providing goods or services to, and/or extending credit to troubled companies, thereby precipitously pushing a company into bankruptcy.

The Berger Industries Case

The debtor and preference plaintiff, Berger Industries, Inc. was a manufacturer of electric couplings and connectors, steel tubing and conduits. Artmark, the

preference defendant, was an importer of industrial components that were crucial to Berger's manufacturing operations. Artmark supplied product to Berger prior to and after the commencement of Berger's bankruptcy case.

On November 16, 1993, seven steel suppliers filed an involuntary bankruptcy petition against Berger. Two days later, Berger obtained entry of an order converting the case to Chapter 11. On November 13, 1995, Berger filed a complaint that sought recovery of \$177,631.36 in alleged preference payments to Artmark during the 90 days prior to the filing of the involuntary petition. The preference action lasted six and a half years and was protracted, bitter and hotly contested. There was never any dispute about Berger's ability to prove all of the elements of a Section 547(b) preference claim against Artmark. At issue throughout the lawsuit was whether Artmark had sustained its burden of proof that the challenged payments were subject to the new value and ordinary course of business defenses and, therefore, not recoverable as preferences.

Recurring efforts to settle the case had proved futile, and discovery disputes frequently occurred. Artmark had initially filed a pretrial motion requesting sanctions for the commencement of the action. The bankruptcy court denied the motion as premature, without prejudice to the refiling of the motion at the conclusion of the lawsuit. In January, 1997, again in July, 1998, and yet a third time when the trial began in July 1999, Berger reduced its preference claim first to \$77,000; then to \$68,735, and finally to \$55,029.37, after conceding in excess of \$120,000 of new value offsets.

In July 1999, the bankruptcy court conducted a two-day trial of the preference action. The trial centered on the ordinary course of business defense. The court dismissed the lawsuit based on Artmark's having proven the applicability of the ordinary course of business defense.

Four months later, Artmark, relying on Bankruptcy Rule 9011, filed a motion

with the bankruptcy court seeking sanctions from Berger's counsel. Bankruptcy Rule 9011 imposes a duty on attorneys to certify that they had conducted a reasonable inquiry into the grounds for the lawsuit they are prosecuting and determined that the lawsuit is meritorious and not interposed for an improper purpose. Artmark sought reimbursement of attorneys' fees and disbursements in the sum of approximately \$100,000, incurred in successfully defending Berger's preference action. Artmark claimed that Berger was required to consider the applicability of possible affirmative defenses to Berger's \$177,000 preference claim prior to commencing suit.

The court denied Artmark's sanctions claim. However, the court did not endorse a rule that precludes sanction claims by successful parties in a lawsuit—the court rejected a *per se* rule negating the requirement for a pre-lawsuit investigation of affirmative defenses to a preference claim. The better view makes any duty of pre-filing inquiry contingent upon the circumstances of the case.

Requiring a plaintiff to anticipate affirmative defenses in order to avoid Bankruptcy Rule 9011 sanctions would improperly reorder the traditional burdens of pleading. Berger had no pre-litigation duty to conduct an inquiry into possible affirmative defenses that Artmark could raise, except for "obvious" defenses that could be proven without discovery.

The court did not consider Artmark's ordinary course of business defense to be obvious when Berger commenced its lawsuit. Sanctions would not have been appropriate where Artmark's ordinary course of business defense was factually complex, and Berger and its counsel lacked all of the necessary facts to determine the applicability of the defense. In fact, Berger's counsel had relied on information from its client that the payments to Artmark were not made in the ordinary course of business between Berger and Artmark. Also, Artmark had the burden of proving that the alleged preference

payments were ordinary in relation to the prevailing practices in its industry, the industrial components industry. Berger's counsel did not have this information and did not have to obtain it prior to commencing the lawsuit.

The court also found that sanctions were not warranted where, during the course of the litigation, Berger had given Artmark credit for increasing amounts of new value and reduced its preference claim by in excess of \$120,000 of new value offsets, first to \$77,000; then to \$60,735; and finally at the beginning of the trial to \$55,029.77. The court commended Berger and its counsel for engaging in "responsible advocacy" by reducing its preference claim by more than \$120,000 of new value offsets, after acknowledging Artmark's new value defense. The court felt this reflected Berger's objective reappraisal of the strengths and weaknesses of its case throughout the litigation, rather than an admission by Berger of a fatal defect in the lawsuit as Artmark had argued.

Conclusion

The court in the Berger Industries case suggested that a trustee or other preference plaintiff cannot prosecute a preference action where the creditor's defenses are "obvious". The court did not find Artmark's ordinary course of business defense to be "obvious" because the defense was factually complex and neither Berger nor its counsel had all of the necessary facts about the existence of the defense. Unfortunately, the court did not consider what constituted an "obvious" preference defense that would have warranted the imposition of sanctions, and gave Berger's counsel a pass in its decision to reduce the preference claim by more than \$120,000 based on numerous acknowledgments of offsettable new value during the course of the litigation.

One wonders how tolerant a court might be where a trustee continues to prosecute a preference litigation after being provided with proof that one or more of the preference checks had bounced, or

with proof of undisputed new value extensions of credit subsequent to the alleged preferences. The United States Bankruptcy Court in Delaware, in *In re Hechinger Investment Co. of Delaware Inc.*, dealt with a sanctions motion against special counsel retained to handle a preference action by deferring a ruling, but commenting that the effort and activity by plaintiff had appeared to be far out of proportion to the small amount at issue in the case, and that the vast majority of preference actions of similar amount were settled after limited discovery. The court was responding to plaintiff's stingy high settlement offer that defendant had rejected in view of its perceived strong ordinary course of business defense, and appeared to be "hinting" that plaintiff's counsel settle the lawsuit!

It will be interesting to see the continued evolution of the case law on the imposition of sanctions for improperly prosecuted preference claims!

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