trustee can recover a preference by satisfying all of the following requirements: (a) the debtor transferred its property to or for the benefit of a creditor [section 547(b)(1)]; (b) the transfer was made on account of antecedent or existing indebtedness that the debtor owed the creditor [section 547(b)(2)]; (c) the transfer was made when the debtor was insolvent, based on a balance sheet definition (liabilities exceeding assets) and presumed during the 90-day preference period to make it easier for the trustee to prove [section 547(b)(3)]; (d) the transfer was made within 90 days of the debtor’s bankruptcy filing, in the case of a transfer to a non-insider creditor [section 547(b)(4)]; and (e) the transfer enabled the creditor to receive more than the creditor would have received in a Chapter 7 liquidation of the debtor [section 547(b)(5)].

Frequently Asserted Preference Defenses
When a debtor or trustee satisfies all of the requirements of an avoidable preference claim, the burden shifts to the preference defendant to reduce or eliminate preference exposure by satisfying the requirements of one or more of the preference defenses contained in section 547(c) of the Bankruptcy Code. These defenses are intended to encourage creditors to continue doing business with, and extending credit to, companies in financial distress.

The section 547(c)(1) contemporaneous exchange for new value defense excuses 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. A creditor that provides new goods and/or services or waives lien rights fully secured by the debtor’s assets substantially contemporaneously with the payment or other transfer replenishes the debtor and should not be forced to return the transfer.

There are two versions of the section 547(c)(2) ordinary course of business defense that could apply in a bankruptcy case. According to the version of section 547(c)(2) that applies to bankruptcy cases filed prior to the October 17, 2005 effective date of the recent changes to the Bankruptcy Code, a transfer is subject to the ordinary course of business defense 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 of business of the debtor and creditor, is straightforward and frequently satisfied by credit extensions to the debtor. The second requirement, payment in the ordinary course of business of the debtor and creditor, requires some consistency between the alleged preference payment and the debtor’s and creditor’s payment history and is regarded as the subjective prong of the ordinary course of business defense. The third requirement, payment according to ordinary business terms, requires proof that the alleged preference was consistent with the payment practices in the relevant industry.

The version of section 547(c)(2) that applies to bankruptcy cases filed on and after October 17, 2005 retains the requirement that the indebtedness paid by the alleged preference was incurred in the ordinary course of business or financial affairs of the debtor and creditor. However, this version of section 547(c)(2) is easier to prove because the creditor must satisfy either the subjective test, requiring a showing of some consistency between the alleged preference payment and the debtor’s and creditor’s payment history, or the objective test, requiring a showing of the payment’s consistency with the range of terms applicable to the relevant industry.
The new value defense, arising under section 547(c)(4) of the Bankruptcy Code, applies where the creditor had provided new value (such as shipping goods or providing services) to the debtor subsequent to the preference. The new value cannot be secured by a security interest in the debtor’s assets that is otherwise unavoidable and cannot be paid by an otherwise unavoidable transfer to or for the creditor’s benefit. The new value defense is designed to protect a creditor from preference risk to the extent the creditor had replenished the debtor by providing new goods or services subsequent to the preference.

The section 547(c)(4) new value defense is not a net result rule. The defense does not provide for a netting of all payments received by the creditor against the new goods and/or services provided by the creditor to the debtor during the 90-day preference period, that would limit preference risk to the extent the payments exceeded the value of new goods and/or services. A creditor determines new value under section 547(c)(4) by offsetting the value of new goods and/or services from only prior, and not subsequent, preference payments.

The section 547(c)(4) new value defense clearly applies to new value that was unpaid on the bankruptcy filing date. Several United States Circuit Courts of Appeal (the federal courts immediately below the United States Supreme Court) and other courts have reached conflicting results on the applicability of the new value defense to paid-for new value. The Third Circuit Court of Appeals (covering New Jersey, Pennsylvania, Delaware and the Virgin Islands) in New York City Shoes, Inc; the Seventh Circuit Court of Appeals (covering Illinois, Indiana and Wisconsin) in Matter of Prescott; and the Eleventh Circuit Court of Appeals (covering Alabama, Florida and Georgia) in In re Jet Florida Systems, Inc. ruled that new value must remain unpaid in order to be eligible as a defense to a preference claim. The Fourth Circuit Court of Appeals (covering Maryland, North and South Carolina, Virginia and West Virginia) in KJK Chrysler-Plymouth; the Fifth Circuit Court of Appeals (covering Louisiana, Mississippi and Texas) in Matter of Toyota of Jefferson, Inc.; the Eighth Circuit Court of Appeals (covering Arkansas, Iowa, Minnesota, Missouri, Nebraska and North and South Dakota) in In re Jones Truck Lines, Inc.; and the Ninth Circuit Court of Appeals (covering Arizona, California, Idaho, Montana, Nevada, Oregon and Washington) in In re IRFM, Inc. ruled that paid-for new value reduces preference exposure as long as the new value was not paid by a “otherwise unavoidable transfer.”

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THE PREFERENCE CHECKLIST

Unsecured trade creditors seeking to analyze and prepare their defenses to a preference claim should consider the checklist below:

1. Bankruptcy Filing
   - Download and save to Excel all available payment history up to two to three years before the commencement of the 90-day preference period.
   - Pull invoice copies and proofs of delivery for all items in payment history.
   - Pull statement of account and all unpaid invoices and proofs of delivery.
   - Pull credit file, including credit application, contract, if any, D&B info, financial statements for the debtor, all notes in file, correspondence and preserve all emails during payment history.

2. Response to Preference Demand Letter
   - Do not ignore the demand.
   - Request a list of all checks that make up the preference claim and copies of cancelled checks or proof of wire transfer with remittance instructions.
   - Check whether all payments claimed as preferences were actually received by the creditor. A payment is made during the preference period based on check clear date. Confirm whether any of the claimed payments were bounced checks (NSF, return to maker, etc.).
   - Statute of Limitations — Determine whether the statute of limitations has expired or will imminently expire. A complaint must be filed not greater than two years from the date of the bankruptcy filing or, if a permanent trustee is selected before the end of the two-year period, not later than the greater of two years after the bankruptcy filing or one year after such selection.
   - If the amount of preference claim is less than $5,000 for bankruptcy cases filed before 4/1/07 and $5,475 for bankruptcy cases filed on and after 4/1/07, a preference lawsuit cannot be commenced.

3. Pre-suit Discussions
   - Communicate defenses to trustee.
   - Consult your attorney.
   - Discussions might not happen if close to expiration of statute of limitations.

4. Receipt of Preference Summons and Complaint
   - Determine answer deadline (usually 30 days from the date of the summons).
   - Try to obtain an extension of time to answer the complaint to provide an opportunity to demonstrate defenses and resolve lawsuit.
   - Immediately refer to counsel if creditor is unable to obtain an extension of time to answer complaint or a default has been entered.
A corporation is not permitted to answer a complaint pro se.
- To the extent not previously done, obtain information regarding the alleged preferences, i.e., list of preference payments and copies of cancelled checks, wire information, payment advices, etc.
- Keep track of discovery requests and deadlines. Immediately refer to counsel if unable to obtain extension of discovery deadlines.

5. Rebuttal of Elements of Preference Claim
- Identify alleged preference payments not received by the creditor.
- Cash in Advance—Determine whether the payments were cash in advance payments (i.e., paid in advance of shipment of goods or provision of services). Cash in advance payments are not preferences because they did not pay antecedent debt and, therefore, do not satisfy one of the requirements of a preference claim.
- Creditor paid out of trust funds (PACA, builders trust fund), which is not property of debtor, is not subject to preference risk.
- Solvency—Check bankruptcy schedules and financial statements covering the preference period or shortly before the preference period to rebut the presumption of insolvency (liabilities exceed assets).
- Creditor fully secured by debtor’s assets, or paid from collateral proceeds is not subject to preference exposure.

6. Preference Defenses
- Contemporaneous Exchange for New Value Defense
  - For COD transactions or payments in exchange for waiver or release of lien rights against the debtor’s property.
  - Although there are no bright line rules as to what constitutes a substantially contemporaneous transfer, a payment made within 10 days of provision of goods or services or waiver of lien should satisfy this defense. The further outside the 10-day period, the less likely this defense applies.
  - The defense is lost if the check bounces and is subsequently replaced, unless in the case of a bounced check in exchange for a lien waiver/release, the waiver/release is conditioned on receipt of good funds.

- New Value Defense
  - Prepare new value analysis and determine the net preference exposure after deducting new value.
  - New value is the value of goods or services provided during the 90-day preference period after receipt of the alleged preference payments. New value cannot be applied towards a check that was received after provision of goods or services.
  - New value should be counted as of the date it was provided—goods shipped, services provided—which might be invoice date.

- Most courts calculate new value after delivery of the payment, rather than clear date of the payment. Delivery is usually receipt of the preference, though some courts do the calculation from date of mailing of the payment.
- New value should include paid and unpaid new value as of the bankruptcy filing date. A caveat, a trustee in a jurisdiction that rejects paid new value might reject deduction of paid for new value; but its applicability as a defense might still be negotiable.

- Ordinary Course of Business Defense
  - To prove the payments were ordinary between the debtor and creditor, the creditor should prepare a payment history (one year/one and a half years/two years/three years before the preference period) that compares the days outstanding prior to the preference period to the days outstanding during the preference period and shows that the average days to payment prior to the preference period was consistent with the days to payment during the preference period. Run different scenarios (different payment history durations) until the desired outcome is reached. Reduced terms during the preference period, change in mode of payment (regular check to wire), change in mode of delivery of payment (regular mail to overnight courier), collection action (threats to cut off shipments, decision to enforce credit limit) and an increased number of invoices paid during or shortly before the commencement of the preference period might result in inability to prove the payment was ordinary between the parties.
  - The creditor can prove ordinary business terms by using industry data from sources such as the Credit Research Foundation, an industry credit group, D&B or comparable data for the creditor’s and debtor’s industries that shows the preference payment terms were consistent with the range of terms in the industry.

- Administrative Claims—Most courts do not consider, as new value, administrative priority claims on account of open invoices for goods and services provided after the bankruptcy filing date. Nonetheless, administrative claims should be asserted as a setoff to the preference and counterclaim and might reduce preference exposure, unless they are time-barred as having not been asserted prior to an administrative claims bar date.

- 7. Settlement
  - Have counsel review settlement agreement.
  - Make sure settlement agreement provides for a general release in favor of the creditor or, at least, waives all preference claims.
  - Do not ignore the value of the creditor’s right under Bankruptcy Code section 502(h) to file an unsecured claim for the settlement amount. That claim could reduce the amount of any settlement payment or provide a later recovery that effectively reduces the settlement amount.