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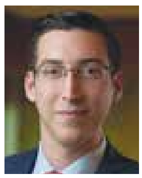
Additional Preference Protection in Recent Stimulus Legislation: Reality or Illusion?





Bruce Nathan, Esq., is a partner in the New York office of the law firm of Lowenstein Sandler LLP, practices in the firm's Bankruptcy & Restructuring Department, and is a recognized expert on trade creditors' rights and the representation of creditors in bankruptcy and other legal matters. He is a member of NACM, a former member of the board of directors of the American Bankruptcy Institute and a former co-chair of ABI's Unsecured Trade Creditors Committee. Bruce is also the co-chair of the Avoiding Powers Advisory Committee working with ABI's commission to study the reform of Chapter 11. He can be reached at bnathan@lowenstein.com.

Eric Chafetz, Esq., is a partner in the New York office of the law firm of Lowenstein Sandler LLP, and practices in the firm's Bankruptcy & Restructuring Department. Creditors' committees, trade creditors, and plan/liquidating trustees involved in complex bankruptcies regularly turn to Eric for strategic counsel on creditors' rights. He also represents secured creditors in connection with their use of cash collateral and related adequate protection issues, as well as advises debtors on various phases of their reorganization efforts. He can be reached at echafetz@lowenstein.com.

Michael Papandrea, Esq., is an associate in Lowenstein Sandler's Bankruptcy & Restructuring Department focused on providing practical solutions for debtors, creditors' committees, individual creditors, and other interested parties involved in bankruptcy and creditors' rights matters. Prior to joining the firm, Mike clerked for multiple bankruptcy judges in the District of New Jersey and Eastern District of Pennsylvania. He can be reached at mpapandrea@lowenstein.com.

The COVID-19 pandemic and related economic shutdowns have wreaked havoc on companies in numerous industries. As a result, many customers have sought extended payment terms, and trade creditors have agreed to defer their payment terms as an accommodation to their struggling customers.

However, such accommodations may have unintended consequences if the customer is financially distressed and eventually files for bankruptcy. Any extended payment terms, or other concessions or changes, may increase the risk that the creditor will be subject to preference liability (*i.e.*, the turnover of payments made to the creditor within the 90-day period before the bankruptcy filing). This increased preference risk arises from the potential loss of the "ordinary course of business" defense, one of the major defenses to preference liability.

In this regard, the Consolidated Appropriations Act of 2021 (CAA)—enacted on Dec. 27, 2020, to provide various forms of economic relief in response to the dislocations that the COVID-19 pandemic caused—may provide some relief to creditors faced with a preference claim. The CAA amends section 547 of the Bankruptcy Code (Section 547) to shield from preference liability "covered payment[s]" of supplier arrearages made pursuant to an "agreement or arrangement" entered into on or after March 13, 2020, to defer amounts owed under an "executory contract." However, the extent to which creditors will benefit from this new exception to preference liability will depend on how the courts interpret the amended statute.

Background: Preference Claims and Defenses

Pursuant to Section 547(b), a trustee (or debtor in possession) can avoid and recover a transfer as a preference by proving the following elements:

- The debtor transferred its property to or for the benefit of a creditor. The most frequent type of transfer is the debtor's payment from its bank account to a creditor [Section 547(b)(1)];
- The transfer was made on account of antecedent or existing indebtedness, such as outstanding invoices for goods sold and delivered and/or services rendered [Section 547(b)(2)];
- The transfer was made when the debtor was insolvent, which is based on a balance sheet test of the debtor's liabilities exceeding its assets and is presumed during the 90-day preference period, which makes insolvency easier to prove [Section 547(b)(3)];
- The transfer was made within 90 days of the debtor's bankruptcy filing (preference period) in the case of a transfer to a non-insider creditor, such as a trade creditor [Section 547(b)(4)]; and
- 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)].

The Small Business Reorganization Act of 2019, which became effective on Feb. 19, 2020, amended Section 547(b) to require a trustee or debtor-in-possession to conduct reasonable due diligence under the circumstances of the case and take into account the creditor's known or reasonably knowable affirmative defenses as part of its burden of proving any preference claim.

There are multiple affirmative defenses contained in Section 547(c) that a creditor can assert to reduce or eliminate its preference exposure. These defenses are intended to encourage creditors to continue doing business with, and extending credit to, financially distressed companies. For example, a creditor may assert the "new value" defense under Section 547(c)(4), which reduces a creditor's preference liability dollar for dollar based on the creditor's sale and delivery of goods and/or provision of services to the debtor on credit terms, after the debtor's receipt of an alleged preference payment.

Alternatively, a creditor may assert the "ordinary course of business" defense to reduce its preference liability. This defense requires a creditor to prove that an alleged preference had paid a debt that the debtor had incurred in the ordinary course of business between the debtor and creditor and was made either in the ordinary course of business between the creditor and debtor, or according to ordinary business terms. A creditor seeking to prove the ordinary course of business defense must show a consistency in the timeliness and other characteristics of the payments made by the debtor to the creditor during the preference period when compared to the payments made prior to the preference period or payments made by customers to their vendors in the applicable industry.

Naturally, then, a creditor that extends the due date of its invoices owing by a financially distressed customer adversely impacted by the COVID-19 pandemic may later suffer unintended consequences if its customer files for bankruptcy and a trustee or debtor-in-possession asserts a preference claim against the creditor. In the world of "no good deed goes unpunished," a creditor's extension of its payment terms to provide relief to a struggling customer may come back to haunt the creditor by increasing its preference exposure as a result of the loss of the ordinary course of business defense.

The CAA's New Preference Exception

The CAA adds a new exception to preference liability effective as of Dec. 27, 2020—found in new Section 547(j)—that appears to be intended to remedy this unfair outcome. Section 547(j)(2)(B) states that a trustee or debtor-in-possession may not avoid a transfer under Section 547 for "*a covered payment of supplier arrearages*."[1] Congress intended this new provision to encourage trade creditors to agree to defer payment of invoices owing by financially distressed customers based on the "covered payment" exception to preference liability.

Courts will grapple with the question: What constitutes a "covered payment of supplier arrearages"? New Section 547(j)(1)(B) seeks to provide that answer, by stating:

(B) The term 'covered payment of supplier arrearages' means a payment of arrearages that—
- (i) is made in connection with an agreement or arrangement—
  - (I) between the debtor and a supplier of goods or services to defer or postpone the payment of amounts due under an executory contract for goods or services; and
  - (II) made or entered into on or after March 13, 2020;
- (ii) does not exceed the amount due under the executory contract described in clause (i)(I) before March 13, 2020; and
- (iii) does not include fees, penalties, or interest in an amount greater than the amount of fees, penalties, or interest—
  - (I) scheduled to be paid under the executory contract described in clause (i)(I); or
  - (II) that the debtor would owe if the debtor had made every payment due under the executory contract described in clause (i)(I) on time and in full before March 13, 2020.

So, to boil down this convoluted statute, a "covered payment" of supplier arrearages is a payment of arrearages in connection with "an agreement or arrangement … made or entered into on or after March 13, 2020," to defer or postpone amounts that a debtor owes a supplier of goods or services under an executory contract. A covered payment cannot include fees, penalties, or interest in an amount greater than what is scheduled to be paid under the contract, or than what the debtor would have owed had the debtor fully made every payment due under the contract before March 13, 2020.

This new preference exception does not have an unlimited shelf life. According to the CAA, Section 547(j) will sunset in two years and will not apply to bankruptcy cases filed on and after Dec. 27, 2022. However, the new "covered payment" exception will continue to apply retroactively to bankruptcy cases filed before the sunset date. Therefore, the exception will only apply in bankruptcy cases filed before Dec. 27, 2022, and, in turn, to qualifying payments made through as late as Sept. 28, 2022.

Key Questions, Open Issues and Takeaways to Consider

Unfortunately, as is too often the case when Congress tinkers with the Bankruptcy Code, the language of Section 547(j) raises numerous questions concerning the extent of the "covered payment" preference exception.

First, it is unclear who holds the burden of proof with respect to Section 547(j). A creditor defending a preference claim based on covered payments of supplier arrearages can argue that the trustee or debtor-in-possession has the burden of proving that the alleged preference payments are not covered payments. In connection with adding new Section 547(j), the CAA amended Section 547(b), which sets forth the elements of a preference claim that a trustee must prove, to reference new subsection (j) among the exceptions to the trustee's preference avoidance power. So, because the "covered payment" exception contained in Section 547(j) is referenced in Section 547(b) and not in Section 547(c), which lists the affirmative defenses to preference claims, the burden arguably rests on the trustee or debtor-in-possession to prove that alleged preference payments are *not*

1 The CAA also added new Section 547(j)(2)(A), which provides that a trustee or debtor-in-possession may not avoid a "covered payment of *rental* arrearages." This additional "covered payment" exception is substantially similar to the "covered payment of supplier arrearages" exception discussed in this article.

covered payments as part of its preference action. However, trustees will likely argue that the creditor has the burden of proving that the preference payments are covered payments as an additional affirmative defense to preference liability. Despite the statutory construction of the CAA's amended Section 547, it is very possible that, in practice, the burden of proof with respect to the "covered payment" exception will fall on the creditor since much of the factual foundation behind asserting a "covered payment" argument will be in the hands of the creditor.

Another important threshold question is, what constitutes an "agreement or arrangement"? The use of the term, "arrangement," suggests something less than an agreement. An "arrangement" could be construed to include less formal modes of modifying payment terms, such as an exchange of emails, or an oral understanding or even a simple handshake. However, it is unclear what factors the courts may consider in determining the existence of an agreement or arrangement to extend payment terms. Therefore, the safest and most conservative route for a creditor seeking to invoke the "covered payment" exception would be for the debtor and creditor to execute a written amendment modifying the distressed customer's payment terms.

Additionally, covered payment exception is limited to payments made pursuant to an executory contract.[2] This suggests that payments on account of the provision of goods or services under individual purchase orders, or less formal arrangements, are not "covered payment[s]" and are subject to preference risk because they are not payments under an executory contract. This ambiguity could lead to extensive litigation as to whether the alleged "covered payment[s]" were made under an executory contract.

It is also unclear whether fees, penalties or interest qualify as covered payments where Section 547(j) states that such charges cannot exceed what "the debtor would owe if the debtor had made every payment due . . . on time and in full before March 13, 2020." This language could be construed to entirely preclude these charges under any new agreement or arrangement from being protected as covered payments as, by definition, these amounts would be in addition to the base amounts due and owing before March 13, 2020. Unless the underlying executory contract includes a provision authorizing fees, penalties or interest, it is hard to imagine what fees, penalties or interest would be owed under an executory contract if the debtor were current as of March 13, 2020. Further, Section 547(j) does not specify whether otherwise qualifying payments made under an agreement or arrangement that violates the limit on fees, penalties or interest would remain entitled to the covered payment exception to preference liability, or if violating the limit on fees, penalties or interest would preclude the creditor from invoking this exception altogether.

Last, but certainly not least, the meaning of the requirement that the payment of arrearages must "not exceed the amount due under an executory contract … before March 13, 2020" is, at best, unclear and open to varying interpretations. One interpretation is that the exception may only be applied to the extent of the amounts that were outstanding under the applicable executory contract as of March 13, 2020—*i.e.*, the beginning of the COVID-related shutdowns. Another interpretation is that the covered payment exception may only be applied with respect to the outstanding claims in existence as of March 13, 2020, and not to any claims incurred on or after March 13, 2020. Under this interpretation, the covered payment exception would also not apply to the payment of arrears under executory contracts that were entered into on and after March 13, 2020. The rationale for this very narrow interpretation is obvious in that, by definition, no amounts could have been due under the contract before March 13, 2020 if the underlying contract did not exist before then. Finally, it is possible that this language is merely intended to prevent the "agreement or arrangement" from adding recurring charges (such as additional fees, interest or other charges) that would not have been incurred under the terms of the underlying contract or lease that existed prior to March 13, 2020. However, this interpretation would seem to make the limitation on additional fees, interest, or other charges discussed above largely duplicative.

Conclusion

The CAA temporarily added subsection (j) to Section 547 to the Bankruptcy Code to provide some preference relief to creditors that have accommodated their distressed customers by deferring or postponing the due date of their invoices. However, despite Congress' presumed intention, and as is typically the case when Congress amends the Bankruptcy Code, any beneficial impact that the CAA may have will largely depend on how the courts interpret Section 547(j) over the coming years. Until courts provide some clarity, creditors should be especially diligent when considering extending the payment terms offered to their customers in light of this new statute. Creditors should document the "agreement or arrangement" to defer or postpone the due dates of invoices owing by their distressed customers in a written amendment that is executed by both parties. Creditors should also avoid including any additional fees or charges beyond the amount that may have been otherwise payable prior to March 13, 2020. And, perhaps most importantly, creditors should be prepared for the harsh reality that the scope of the CAA's new covered payment exception may be very limited and, in practice, this new statutory exception may ultimately provide minimal additional preference protection.

2 The most widely used definition of an "executory contract" is the Countryman definition, that an executory contract is one under which both parties to the contract have unperformed obligations such that the failure of either party to continue or complete performance would constitute a material breach that excuses the other party from performance.