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Preference Defense in the Wake of the Pandemic: A Primer

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Nothing is more frustrating to a trade creditor holding a large unpaid balance owed by a debtor in bankruptcy than the risk that payments the trade creditor received before the debtor filed bankruptcy may be clawed back by the debtor's estate as "preference" payments. This frustration has been compounded since the onset of the COVID-19 pandemic early last year, during which time vendors have supported struggling customers by agreeing to defer or postpone payments under the terms of their goods or services contracts, even while the vendors themselves may have struggled to stay afloat. Pursuant to section 547(b) of the Bankruptcy Code, a debtor in possession or a trustee can seek to recover certain payments made within 90 days of the bankruptcy filing date, subject to various defenses.

The policy behind the preference statute is to treat creditors equitably and level the playing field by requiring preferred creditors to share their recovery with all other creditors. Paradoxically, however, when the estate recovers preference payments made to a particular creditor, that creditor often will not share in the recovery at all. Pursuant to the absolute priority rule, higher-priority claims, such as secured claims, unpaid chapter 11 administrative expense claims incurred by the debtor (such as professional fees), and other priority claims typically all must be paid in full before unsecured creditors receive any distribution. With increasing frequency, and particularly in retailer bankruptcies, preference recoveries are used to fund chapter 11 administrative expenses and to improve the recoveries of underwater secured lenders rather than to facilitate pro rata distributions to unsecured creditors–not at all what Congress intended when it enacted the statute. While the preference statute is intended to promote fairness and equity among creditors, the creditor that finds itself defending a preference action is more likely to characterize the action as punishment for continuing to support a financially distressed customer.

So, what should a creditor do when it first receives a preference demand letter? What should it do when it is subsequently sued? What arguments and defenses can the creditor raise in opposition to a preference claim? How should the creditor go about putting this information to use when responding to, defending, and (hopefully) settling the preference claim? This article answers these questions, including by providing a list of action items that a creditor should be mindful of, beginning with the date that a customer files for bankruptcy–the "petition date"–through the resolution of a preference litigation. Creditors are nearly always far better off spending the time compiling and presenting proof of potential defenses to a preference demand than simply paying the amount demanded.

Some Necessary Background: Preference Claims and Defenses

The Elements of a Preference Claim

Pursuant to section 547(b) of the Bankruptcy Code, a trustee, a debtor in possession, or a successor to the estate such as a liquidating trust can avoid and recover a transfer of property of the debtor as a preference by proving all the following required elements:

- The debtor transferred its property to or for the benefit of a creditor (the transfer of any type of property can be avoided, but the most frequent type of transfer is the debtor's payment from its bank account to a creditor) [§ 547(b)(1)].
- The transfer was made on account of antecedent indebtedness–a debt that existed before the transfer was made–that the debtor owed to the creditor, such as outstanding invoices for goods sold and delivered or services rendered [§ 547(b)(2)].
- The transfer was made when the debtor was insolvent, which is based on a balance sheet test–liabilities exceeding assets (insolvency is presumed during the 90-day preference lookback

period, making this element easier to prove, although the creditor can present evidence to rebut this presumption) [§ 547(b)(3)].

- The transfer was made within 90 days of the debtor's bankruptcy filing where the transfer was to a non-insider creditor, such as a typical trade creditor, or within one year if the transfer was to an insider [§ 547(b)(4)].

- The transfer enabled the creditor to receive more than the creditor would have received in a chapter 7 liquidation of the debtor (the "preference" element of a preference payment) [§ 547(b)(5)].

The Small Business Reorganization Act of 2019 (SBRA), which became effective on February 19, 2020, amended section 547(b) to require the plaintiff in a preference suit to allege, as part of its burden of proof, that the preference claim is based on reasonable due diligence in the circumstances of the case and takes into account a party's known or reasonably knowable affirmative defenses. This seemingly heightened burden of proof for preference claims has raised numerous questions that will need to be answered by the courts. How much of an additional burden will be placed on a plaintiff to prove a preference claim? What constitutes "reasonable due diligence"? What is a "reasonably knowable affirmative defense"? And can the plaintiff in a preference action rely on the debtor's records to satisfy these requirements, or must the plaintiff engage in additional diligence? Given the relatively short time this change has been in place, few courts have had occasion to address these questions.

Defenses to a Preference Claim
Section 547(c) of the Bankruptcy Code provides several affirmative defenses that a creditor can assert to reduce or eliminate its preference exposure. These defenses are designed to encourage creditors to continue doing business with and extending credit to financially distressed companies. In the rare case that goes to trial, the creditor bears the burden of proving its defenses.

§ 547(c)(1)–Contemporaneous Exchange of Value: The contemporaneous exchange of value defense, set forth in section 547(c)(1), is one such defense. This defense excuses any payment or other transfer that the debtor and creditor had *intended* as a contemporaneous exchange for new value and that was a substantially contemporaneous exchange. A creditor that provides new goods or services to a debtor in exchange for a substantially contemporaneous payment, such as a cash-on-delivery transaction, replenishes the debtor and should not be subject to preference liability.

§ 547(c)(4)–Subsequent New Value: The subsequent new value defense, set forth in section 547(c)(4), is perhaps the most frequently invoked preference defense. The new value cannot be secured by a security interest in the debtor's assets that is otherwise unavoidable, and it cannot be paid by an otherwise unavoidable transfer to or for the benefit of the creditor. The subsequent new value defense reduces a creditor's preference liability dollar for dollar based on new value provided to the debtor–such as sale and delivery of goods or provision of services to the debtor on credit terms–*after* the creditor's receipt of an alleged preference payment. The defense is predicated on protecting a creditor from preference risk where the creditor replenished the debtor by continuing to extend credit after receiving a transfer otherwise alleged to be a preference.

The section 547(c)(4) new value defense clearly applies to new value that was *unpaid* as of the petition date. Several United States Circuit Courts of Appeals (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* new value–value that the creditor provided to the debtor after receiving an alleged preference payment but that the debtor repaid before the petition date. The majority view–followed by the Fourth, Fifth, Eighth, Ninth, and, most recently, Eleventh circuits and many lower courts–has applied the new value defense to new value paid by an otherwise avoidable transfer (such as a subsequent preference payment) and unpaid new value. On the other hand, the Seventh Circuit and a minority of other courts have ruled that the new value defense applies only to unpaid new value. A creditor's ability to assert paid new value, in addition to unpaid new value, could substantially reduce preference liability but depends on the jurisdiction in which the debtor filed bankruptcy.

In certain instances, new value provided before the petition date might be paid after the petition date pursuant to an order authorizing the debtor to pay "critical vendor" claims or administrative claims arising under section 503(b)(9) of the Bankruptcy Code. As discussed later in this article, a creditor may have some or all of its prepetition claim paid after the petition date by being deemed a "critical vendor" during the bankruptcy case. Also, a creditor may be granted an allowed administrative expense claim under section 503(b)(9) of the Bankruptcy Code for the value of goods received by the debtor within 20 days before the petition date (a "§ 503(b)(9) claim"). Courts are divided on whether new value that is paid *after the petition date* pursuant to a critical vendor order or as an allowed § 503(b)(9) claim nevertheless can be used to reduce preference liability as subsequent new value. Some courts, including the Third Circuit (whose rulings are binding on the lower federal courts in Delaware, New Jersey, Pennsylvania, and the United States Virgin Islands), have held that such new value may still count toward the new value defense, because new value is determined based on a "snapshot" as of the petition date. Other courts have denied the application of such new value toward the new value defense, largely under the premise that permitting such new value would permit the creditor to "double-dip" by reducing its preference exposure based on credit extended before the petition date where such credit was fully paid after the petition. This issue, specifically as it relates to § 503(b)(9) claims, is presently on appeal in the Eleventh Circuit.

§ 547(c)(2)–Ordinary Course of Business: Another frequently invoked defense is the "ordinary course of business" defense set forth in section 547(c)(2) of the Bankruptcy Code. The creditor must first prove the alleged preference payment satisfied a debt that the debtor incurred in the ordinary course of business or financial affairs of the debtor and the creditor. A trade creditor that extended credit to the debtor should have little difficulty satisfying this requirement. The creditor must then prove the preference payment was *either* (A) made in the ordinary course of business or financial affairs of the debtor and the creditor (the subjective test), *or* (B) made according to ordinary business terms (the objective test). The subjective test requires proof that the alleged preference payments were consistent with the debtor's payments to the creditor prior to the preference period. A creditor can prove the objective part of the defense by showing that the alleged preference payments were consistent with the terms and payment practices in the creditor's industry, the debtor's industry, or some subset of either or both. Needless to say, this defense is fact-intensive, and courts and parties have approached it in a wide variety of ways.

During the COVID-19 pandemic, vendors and customers frequently negotiated extended terms for the payment of invoices. If a customer subsequently filed for bankruptcy protection and sought to recover payments made to the vendor as alleged preferences, the vendor–by giving the customer more time to pay–risked losing the ordinary course of business defense. To address this seemingly unfair result, Congress, through the Consolidated Appropriations Act of 2020 (CAA), which became effective on December 27, 2020, amended section 547 to create a new, temporary preference exception in new subsection (j), under which "covered payment[s] of supplier arrearages"[1] may not be avoided as preferences. According to section 547(j)(1)(B), a "covered payment of supplier arrearages" means a payment of arrearages that is made in connection with an agreement or arrangement made or entered into on and after March 13, 2020 (the generally recognized onset of the COVID-19 pandemic in the United States), between a debtor and a supplier of goods or services to delay or postpone payment of amounts due under an executory contract. The payment of arrearages cannot exceed the amount due under the contract before March 13, 2020, and does not include fees, penalties, or interest in an amount greater than that scheduled to be paid under the contract or which the debtor would owe if the debtor had made all payments on time and in full before March 13, 2020. As with the SBRA's amendment to section 547, this statutory language leaves much unanswered about the scope and application of this new exception that the courts will need to decide. Absent further congressional action, this temporary provision expires on December 27, 2022, but will continue to apply to bankruptcy cases filed before that date.

Critical Vendors: Another defense creditors have asserted with mixed success is the "critical vendor defense." Chapter 11 debtors frequently seek and obtain authority to pay the prepetition claims of "critical vendors" based on the premise that the debtors' businesses would be irreparably disrupted and their efforts to maximize value for their estates and creditors would be severely impaired if such vendors refuse to continue extending credit. When defending preference actions, creditors that have been granted critical vendor status have argued that a preference claim against them must fail in light of the fact that the court granted authority for the debtor to pay the creditor's prepetition claim, because the plaintiff cannot prove one of the necessary elements of the claim–that the alleged preferential transfer enabled the creditor to receive more than the creditor would have received in a hypothetical chapter 7 bankruptcy liquidation. This argument has had mixed success, largely depending on whether the estate was required to pay the creditor's prepetition claim or merely had discretionary authority to do so. Under the latter circumstance, courts tend to uniformly reject the critical vendor defense. Therefore, creditors considering extending credit to a debtor after the petition date in exchange for the payment of prepetition claims pursuant to a critical vendor order in the bankruptcy case should carefully review how the debtor's critical vendor program is structured and should consider entering into a trade agreement that requires payment of the prepetition claim if the creditor wishes to minimize the risk of preference liability.

<u>Preference Action Items</u>

Unsecured trade creditors seeking to analyze and prepare their defenses and respond to a potential or asserted preference claim should be mindful of the action items listed below, beginning even *before* receiving a preference demand:

1. **Upon Receiving Notice of a Customer's Bankruptcy Filing:**
    a. Download and save to an Excel file all available payment history covering the two-to-three-year period before the commencement of the 90-day preference lookback period. The history should identify each invoice paid by each payment and the dates and amounts of such invoices.

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[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.

b. Pull copies of all invoices (paid and unpaid) for goods and services provided during the preference lookback period, proofs of delivery, and a statement of account showing all unpaid invoices on the petition date.

c. Pull and secure the credit file for the customer–including the credit application, contracts, and financial statements for the debtor; all notes in the file; and all correspondence and e-mails generated during the period covered by the parties' payment history.

2. **Upon Receipt of a Preference Demand Letter:**
   a. Do not ignore the demand!

   b. Identify all payments received from the customer within 90 days before the petition date.

   c. Request that the party asserting the demand (typically the debtor, chapter 7 trustee, or liquidating trustee) provide a list of all payments that are included as part of the preference claim, a list of the invoices paid by each alleged preference, and proof that the payment was received.

   d. Verify whether the alleged preference payments were actually received during the 90 days before the petition date. Determine whether any of the alleged payments "bounced."

   e. Determine whether the statute of limitations has expired or will expire imminently. A complaint asserting a preference claim must be filed no later than two years after the petition date, or if a trustee is appointed before the expiration of the two-year period, no later than the longer of (i) two years after the bankruptcy filing or (ii) one year after the trustee's appointment.

   f. Be aware of the "small preference defense." A creditor has a *full defense* to a preference claim for recovery of less than $6,825 in bankruptcy cases commenced after April 1, 2019, and for recovery of less than $6,425 in cases commenced from April 1, 2016, through April 1, 2019. While creditors might receive demands for recovery of these small preference claims, it is unlikely that litigation actually will ensue.

   g. Determine the proper venue for a preference lawsuit. Thanks to the SBRA, for lawsuits commenced on or after February 19, 2020, if the preference claim is less than $25,000, the suit must be filed in the defendant's "home" district (prior to February 19, 2020, the threshold was only $13,650).[2] Trustees and debtors may be less likely to commence a preference lawsuit if the lawsuit must be brought in a jurisdiction other than where the bankruptcy case is pending.

   h. Do not assume that a preference claim is valid, can be proven, or is indefensible merely because the trustee or debtor has sent a demand letter! In many instances, a debtor or trustee will mass-mail preference demand letters to try to collect the "low-hanging fruit" from creditors that do not take the time to review their defenses. Also, the demand letter may be an empty threat, as a debtor or trustee may be less likely to actually file preference complaints based on the creditor's defenses. For example, it is unlikely that a debtor or trustee would commence a lawsuit to collect a small preference claim (claims for recovery of less than $6,825 in bankruptcy cases commenced after April 1, 2019) because of the small preference defense, discussed in 2.f above. Also, if the demand is for less than $25,000, a debtor-in-possession or trustee may be hesitant to file a complaint and litigate the case in the creditor's home district, as discussed in 2.g above. And again, a debtor or trustee may be discouraged by the seemingly heightened pleading standards that the SBRA recently added to section 547(b) for the filing of a preference complaint where the creditor has clear and undisputed defenses.

3. **Rebut the Elements of the Preference Claim.** It is absolutely critical to consider whether any of the elements of the preference claim can be rebutted:
   a. Solvency: Review the debtor's bankruptcy schedules and financial statements covering the preference period and shortly before the preference period to seek to rebut the presumption of the debtor's insolvency (i.e., that its liabilities exceeded its assets) when the preference payments were made.

   b. Antecedent Debt/Cash in Advance: Assess whether the payments were indeed on account of an antecedent debt or instead were cash-in-advance payments made before shipment of goods or provision of services. To constitute an avoidable preference payment, a payment must be on account of an antecedent debt. Cash-in-advance payments are not preference payments at all because they are not on account of an antecedent debt!

   c. Property of the Estate: Determine whether the payments were made from property of

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[2] It could be argued that the SBRA's new venue threshold applies more narrowly to bankruptcy *cases* (as opposed to lawsuits) filed on or after February 19, 2020.

the debtor's estate. For example, certain trust funds (such as those arising from state builders trust fund and/or construction trust fund statutory and case law, the federal Perishable Agricultural Commodities Act, and the Packers and Stockyards Act) may not be considered property of the debtor's estate. As a result, payments from such trust funds are not transfers of property of the debtor and are not preference payments.

d. **Secured Claims and Assumed Contracts:** There are certain circumstances where payments are not subject to preference exposure at all. For example, where a creditor's claim is fully secured by the debtor's property or the creditor was paid by the proceeds of its collateral, there is no preference exposure. A creditor's fully secured status could be based on the filing of a lien under state law, the grant of a security interest in the debtor's assets, or a creditor's setoff rights. Alleged preference payments made under a contract that the debtor properly assumes in its bankruptcy case also are not recoverable as preferences, because all amounts owing under such contracts must be satisfied as a condition to assumption.

4. **Evaluate Potential Defenses and Counterclaims:**
   a. The "New Value" Defense:
      i. Prepare an analysis of all goods and services provided on credit after the receipt of each alleged preference payment to determine the net exposure after deducting such new value. A payment schedule outlining in chronological order both the goods and services provided and each alleged preference payment is ideal for evaluating this and other potential defenses and counterclaims.

      ii. New value is the value of goods or services provided on credit during the 90-day preference period *after* receipt of each alleged preference payment. New value offsets only prior payments; it cannot be carried forward and applied against future preference payments. New value should be counted as of the date the new value was provided, which can be determined from the shipping documents.

      iii. New value should include paid and unpaid new value as of the petition date. Note that a plaintiff in a jurisdiction that rejects paid new value might reject the application of new value that the debtor repaid before the petition date to reduce the alleged preference claim. Nevertheless, a creditor should still include paid new value when asserting the defense for purposes of negotiations.

   b. The "Ordinary Course of Business" Defense:
      i. Prepare a payment history (covering the two-to-three-year period prior to the petition date) comparing the days invoices were outstanding during the pre-preference period to the days invoices were outstanding during the preference period to show that the timing of payments during the preference period was consistent with historical trends. The courts have adopted different approaches in determining consistency of payments prior to and during the preference period. Some courts use a range of payments analysis, finding that any alleged preference payment that falls anywhere within the historical range of payment timing satisfies the subjective test. Other courts have applied a modified historical range of payments analysis, applying the subjective element of the ordinary course of business defense to alleged preference payments that fall within a modified historical range of payments, excluding outliers or unusual payments. Another group of courts compares the average days to pay invoices prior to and during the preference period and applies the subjective ordinary course of business defense where there is a nominal variance between the average days to pay before and during the preference period.

      ii. Be mindful that the ability to assert the subjective ordinary course of business defense may be diminished due to actions taken shortly before or during the preference period, such as reduced terms, changes in the mode of payment (e.g., regular check to wire transfer), changes in the mode of delivery (e.g., regular mail to overnight courier), collection actions (e.g., threats to cut off deliveries or pull advertising), and other forms of payment pressure. This risk may be mitigated to some extent for certain creditors in light of the new preference exception in section 547(j) discussed above for certain payments made in connection with an arrangement or agreement to delay payment of amounts due under an executory contract. However, as noted above, courts will have to define the scope and application of this new exception. There is a real risk that the exception will be very limited and will not insulate the creditor from exposure if the issue is litigated in court. Nevertheless, creditors should still raise the exception to facilitate a settlement of the preference claim.

      iii. A creditor can prove ordinary business terms by using industry data from sources such as the Credit Research Foundation, industry credit groups, and various commercial data sources to show that the preference payment terms and timing were consistent with the range of terms and days outstanding in the applicable industry.

c. Unpaid "Administrative Expense" Claims:
   i. Assess whether the creditor has any unpaid administrative expense claims for goods or services provided after the bankruptcy filing.

   ii. Though most courts do not treat unpaid administrative expense claims as part of a creditor's new value defense, unpaid administrative expenses can be asserted as an affirmative defense and counterclaim to reduce preference liability. Note that a debtor or trustee will likely oppose the assertion of time-barred administrative expenses that were not timely asserted prior to an administrative claims bar date, if applicable.

   iii. If the creditor has an unpaid administrative priority claim, a debtor or trustee may argue that its preference claim against the creditor provides a basis to disallow the creditor's claim under section 502(b) of the Bankruptcy Code. A number of courts have rejected this argument, but creditors should be aware of and prepared to respond to it.

5. **Before the Plaintiff Commences a Lawsuit:** If you have not already done so, *consult an attorney*. Communicate all potential defenses to the plaintiff. If the demand letter was sent close to the expiration of the statute of limitations (the deadline for the debtor or the trustee to assert the preference claim in a complaint), there may not be sufficient time for meaningful settlement negotiations before the suit is filed. However, settlement discussions can and typically should continue even after the suit is filed.

6. **Answering a Summons and Complaint:**
   a. Determine the deadline to answer the complaint (usually approximately 30 days from the date of the summons).

   b. Seek an extension of the answer deadline in order to try to resolve the lawsuit or, if necessary, retain counsel to prepare the answer.

   c. Immediately consult and refer to legal counsel if the answer deadline cannot be extended or if a default or default judgment has been entered. It is important to note that a corporation cannot represent itself in federal court, so a creditor *must* retain outside counsel before filing an answer or other pleadings with the bankruptcy court.

   d. To the extent not done previously, gather internally and request that the plaintiff provide any information regarding the alleged preference payments, such as a list of the alleged payments and copies of cancelled checks, wire, or other payment information, etc.

   e. Make sure to keep track of any hearing dates, discovery requests, and deadlines. Immediately consult with and refer to counsel if unable to obtain extensions of discovery or other deadlines.

7. **Documenting a Settlement:**
   a. Enter into a formal settlement agreement with the guidance of counsel.

   b. Make sure the settlement agreement provides for a general release in the creditor's favor, or at least waives all preference and other avoidance claims.

   c. Do not ignore the value of the creditor's right, under section 502(h) of the Bankruptcy Code, to file an unsecured claim for the settlement amount. Such a claim could reduce the amount of any settlement payment or provide a later recovery that effectively reduces the settlement amount.

Conclusion

Notwithstanding Congress' recognition of the realities of doing business during the COVID-19 pandemic, and indeed in light of the recent amendments to the Bankruptcy Code concerning preferences, it is absolutely critical for trade creditors to be prepared to address and respond to potential preference claims following a customer's bankruptcy filing. The information and action items provided above are a great start for doing so. However, upon receipt of a demand letter or a preference complaint, a trade creditor should consult an attorney to assist in the defense of the claim and to help navigate the choppy and unclear waters underlying preference risk.

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