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The “Catch-22” of Preference Law

By Keara Waldron and Michael Papandrea
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Keara Waldron: For anyone who has done business with a distressed company, the word “preference” may instill feelings of uneasiness, frustration, or downright fear.

Michael Papandrea: Here at Lowenstein, we keep an ever-watchful eye on the evolving minefield that is preference law, and Keara and I from Lowenstein’s Bankruptcy & Restructuring Department are here to talk to you today about some recent developments in case law.

Keara Waldron: For those of you who haven't had the distinct pleasure of being subject to a preference suit, the Bankruptcy Code allows a debtor and possession or trustee to claw back certain payments or transfers that are made in the 90 days prior to the bankruptcy petition being for all on the theory that those payments “preferred” one creditor over another.

Michael Papandrea: This creates a harsh catch-22 for vendors dealing with financially distressed customers. Those very same actions that a creditor might take to protect itself such as imposing credit limits, tightening terms, or otherwise ramping up collection efforts might actually cost the creditor its defense in the event it finds itself hit with a preference claim down the road.

Keara Waldron: This catch-22 was illustrated in the recent decision of *H.H. Gregg* pending in the Southern District of Indiana. There, one of the debtor's critical vendors was able to pay down the full extent of its accounts receivable prior to the bankruptcy, receiving approximately $4.7 million in the 90 days prior to the petition date. After the case was filed, the bankruptcy estate brought a lawsuit to claw back those payments.

Michael Papandrea: The supplier argued one of the most common defenses to a preference claim: that the payments made during the preference period were made consistently with the historical practices between the parties prior to the preference period back when the debtor was financially healthy. This is commonly referred to as the ordinary course of business defense. And in fact, in *H.H. Gregg*, the creditor was successful in proving to the court that the payments made during the preference period to the supplier were in fact consistent with the historical practices between the parties back when H.H. Gregg was financially healthy.

Keara Waldron: However, the collection practices that were employed by the supplier during the preference period, such as tightening terms, ramping up collection efforts, sending emails and calls from senior executives, threatening to withhold shipments unless payment was received, ultimately compromised the supplier's ability to take advantage of the ordinary course of business defense. While the supplier never actually withheld goods, the Court found that the efforts employed by the supplier denied its ability to take advantage of the ordinary course of business defense. Ultimately, the Court found that the debtors were prioritizing the payments to the supplier when its liquidity was otherwise compromised.

Michael Papandrea: So, even though the preference period and pre-preference period payment history was largely consistent with one another, the creditor still failed to prove its ordinary course of business defense. And the Court did say that it was not an easy call since neither side had definitively tipped the scales in its favor, but the creditor defendant has the burden of proving its defense by a preponderance of the evidence. In other words, a tie goes to the bankrupt debtor's estate.

Keara Waldron: The H.*H. Gregg* decision urges caution. While it's impossible to know how the debtor would've otherwise behaved in the absence of the payment pressure exerted by the supplier, this decision suggests that even a payment that would otherwise be considered ordinary compared to the historical dealings between the parties may still be subject to clawback in the presence of payment pressure.

Michael Papandrea: Compare the *H.H. Gregg* decision with another decision that came out barely three weeks later from a New York bankruptcy court in the Chapter 11 cases of *Décor Holdings*. In that case, the bankruptcy court conducted a relatively straightforward ordinary course of business analysis and concluded that the payments made during the preference period and before the preference period were largely consistent with one another and without any evidence of increased collection pressure to sway the Court otherwise, the creditor had prevailed, in proving its ordinary course of business defense. These two cases issued at almost the same exact time as one another really illustrate the key role that increased collection pressure can play in an otherwise airtight ordinary course of business defense.

Keara Waldron: As always, we here at Lowenstein will continue to monitor all preference related developments and keep you apprised of any future interesting decisions.