

SAFE ASSUMPTION:

Another Court Rules That Payments Under an Assumed Contract Cannot be Clawed Back as Preferences

THE LEGISLATIVE PURPOSE OF THE **PREFERENCE STATUTE IS TO TREAT CREDITORS FAIRLY.**

TRADE CREDITORS THAT RECEIVE PAYMENTS FROM DISTRESSED CUSTOMERS UNDER SUPPLY AGREEMENTS, LONG-TERM PURCHASE ORDERS, AND OTHER EXECUTORY CONTRACTS CAN REST A BIT MORE ASSURED THANKS TO A RECENT DECISION BY THE UNITED STATES BANKRUPTCY COURT FOR THE DISTRICT OF IOWA.

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In *In re Mercy Hospital,* the Iowa bankruptcy court dismissed a preference action by relying on the well-established principle that when a debtor assumes an executory contract under section 365 of the Bankruptcy Code, the bankruptcy estate cannot later claw back payments made before the bankruptcy filing under that same contract as preferences under section 547. In the court's words, assumption under section 365 and preference recovery under section 547 are "mutually exclusive remedies."

For trade creditors that supply goods or services under ongoing contracts, the *Mercy Hospital* decision provides another strong authority to cite when pushing back against a preference demand. Read on to learn *how the Mercy Hospital* court reached its conclusion—and what trade creditors should take away from the decision.

WHAT IS A PREFERENCE?

A debtor or trustee in bankruptcy can seek to recover payments made to creditors before the bankruptcy filing as a "preference" by proving the following:

1. The debtor had transferred property of the debtor's estate (such as a debtor's payment from its bank account);
2. To or for the benefit of a creditor;
3. On account of an antecedent debt (e.g., an outstanding invoice; so cash in advance payments are not preferences!);
4. On or within the 90 days before the bankruptcy filing (or within a year before the filing, if the transfer was to an "insider");
5. While the debtor was insolvent (which is presumed during the 90-day preference period); and
6. The transfer enabled the creditor to recover more than the creditor otherwise would have received in a hypothetical chapter 7 bankruptcy case (the "hypothetical liquidation" element).

The legislative purpose of the preference statute is to treat creditors fairly, by giving a bankruptcy trustee or other estate fiduciary the ability to recover prepetition payments made to "preferred" creditors so that the recovered proceeds can be distributed equally among all similarly classified creditors. But to the creditor that is the target of a preference claim, the process is anything but fair. This is particularly true given the unfortunate reality that in many cases, preference claims are used to fund the administrative expenses entitled to priority status that accrued during the bankruptcy case.

Section 547(c) of the Bankruptcy Code arms creditors with affirmative defenses they can assert to minimize or eliminate preference liability where the plaintiff has otherwise proven the elements of a preference claim. These defenses are intended to encourage creditors to continue doing business with and extending credit to financially distressed customers.

But affirmative defenses to a preference claim are not the only line of defense available to a trade creditor. In some circumstances, other provisions of the Bankruptcy Code may operate to bar a preference claim altogether—as the *Mercy Hospital* decision illustrates. In that case, the key statutory provision was section 365 of the Bankruptcy Code, which governs a debtor's ability to assume or reject executory contracts, and one of the elements of a preference claim, the greater than hypothetical liquidation element contained in section 547(b)(5).

A (VERY) SHORT PRIMER ON CONTRACT ASSUMPTION AND REJECTION IN BANKRUPTCY

Section 365 of the Bankruptcy Code authorizes a debtor to either assume or reject its executory contracts—i.e., contracts where both sides still have obligations to perform. If a debtor rejects an executory contract, the debtor is excused from continuing performance under the contract and is deemed to have breached the contract as of the moment immediately before the bankruptcy filing. The non-debtor counterparty is entitled to assert a claim for damages arising from the debtor's rejection (i.e., breach) of the contract, but that claim is treated as a prepetition general unsecured claim. As such, rejection is a very powerful tool for debtors seeking to shed unprofitable, burdensome, or otherwise unnecessary contracts.

Alternatively, a debtor may assume an executory contract ***provided that the debtor cures any outstanding defaults (i.e., pays all past due invoices, including prepetition invoices) and provides adequate assurance of future performance***. By assuming the contract, the debtor is effectively agreeing to continue to perform under the contract. The debtor also might assign the assumed contract and corresponding obligations to a third party, such as a purchaser of the debtor's operating business. The *Mercy Hospital* decision emphasizes the impact that decision has on potential preference claims against the non-debtor counterparty to the assumed and assigned contract.

BACKGROUND REGARDING THE *MERCY HOSPITAL* DECISION

In August 2023, Mercy Hospital, Iowa City, Iowa (the "Debtor") filed for Chapter 11 bankruptcy. Before filing, the Debtor and PeriGen, Inc. ("PeriGen" or the "Defendant") were parties to a Software License and Support Agreement, subsequently amended by a First Amendment to Software License and Support Agreement (together, the "Licensing Agreement"). Under the Licensing Agreement, the Debtor made recurring payments to PeriGen in exchange for software and support services. Shortly after filing for bankruptcy, the Debtor assumed the Licensing Agreement and assigned it to the University of Iowa, the eventual purchaser of the hospital.

Subsequently, the Liquidation Trustee of the Mercy Hospital Liquidation Trust filed an adversary proceeding against PeriGen seeking to avoid and recover, as preferences, payments in the aggregate amount of $28,347.75 made to PeriGen between May 2023 and August 2023 (i.e., during the 90-day preference period).

PeriGen moved to dismiss the complaint, arguing the Trustee's preference claims must fail as a matter of law because the Trustee could not prove the hypothetical liquidation element. The debtor assumed the contract under which the alleged preference payments were made, and, therefore, would have had to pay all past due (e.g., prepetition) amounts owed under the contract—so the alleged preference payments did not enable PeriGen to receive more than it otherwise would have received in a hypothetical chapter 7 case.

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THE BANKRUPTCY COURT'S RULING

The bankruptcy court granted PeriGen's motion to dismiss, holding that assumption of an executory contract under section 365 effectively precludes a preference claim to recover prepetition payments made under that contract.

The court noted that the majority of courts to address this issue have held reached the same holding, including the United States Courts of Appeals for the Third, Seventh, Ninth, and Eleventh Circuits. When a contract is assumed under section 365, the debtor must cure any defaults and provide adequate assurance of future performance. As such, PeriGen effectively stood in a position analogous to that of a secured creditor, entitled to full payment of its claim. A preference action is designed to recover payments that gave a creditor more than it would have received in a hypothetical chapter 7 liquidation. Where a creditor becomes entitled to full payment of its claim by virtue of the debtor's assumption of its contract, it is impossible for any prepetition payments to have caused the creditor to receive more than it otherwise would have received in a chapter 7 case.

The bankruptcy court rejected the Trustee's argument for a "plain reading" of section 547(b) that courts cannot consider post-petition events (e.g., the assumption of a contract), when analyzing the hypothetical liquidation element. As the court explained, "the status of the [contract creditor's] right to payment from the estate is not yet fixed" as of the petition date. The creditor's ultimate treatment depends entirely on whether the contract is assumed or rejected afterward.

The court also noted that the Trustee's argument was self-defeating. Classifying PeriGen as a general unsecured creditor (as the Trustee needed to do to satisfy the greater than chapter 7 liquidation element of his preference claim) also necessarily relies on a post-petition event—i.e., *rejection* of the contract. The Trustee could not simultaneously argue that post-petition events (assumption) should be ignored while relying on the inverse post-petition event (rejection) to prove his own case.

As a practical matter, the bankruptcy court focused on the absurd results that would follow from the Trustee's position. The Debtor had paid PeriGen in full before the bankruptcy filing. Because there were no defaults to cure, no cure payment was required as a condition of assuming the Licensing Agreement. Under the Trustee's theory, PeriGen would be forced to return its prepetition payments to the estate, and then the Trustee should have to turn right around and pay PeriGen back in full to satisfy the cure obligation under section 365. The court concluded that this circular absurdity could not be what Congress intended. Instead, Congress passed section 365 to insure that the non-debtor contract counterparty is made whole before the court can compel that party to continue its performance under an assumed contract. Permitting the recovery of a preference claim against that counterparty after assumption of the contract would undermine Congress' intent.

CONCLUSION

The *Mercy Hospital* decision is a welcome addition to the preference defense arsenal for trade creditors, particularly those that supply goods or services under executory contracts such as software licenses, service agreements, and supply contracts. While the principle is well established, the decision reinforces the rule that sections 365 and 547 are mutually exclusive remedies: once a debtor or trustee assumes a creditor's contract, prepetition payments made under that contract cannot be clawed back as preferences. BC



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