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Rebutting a Trustee's Preference Claim: A Creditor's First Line of Defense


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Preference claims are the ultimate thorn in the side of a trade creditor dealing with a customer that files for bankruptcy or is heading toward a potential bankruptcy filing. Collecting outstanding invoices is difficult enough in these circumstances—the risk of having to return payments a creditor has managed to collect in the months before a bankruptcy filing is, simply adding insult to injury.

Defending a preference claim starts with rebutting one or more of the elements that a plaintiff must prove to recover an alleged preference. However, this is frequently an uphill battle because of the advantages that make it easier to prove a preference claim. A recent decision from the Colorado bankruptcy court in the Chapter 11 case of *Sklar Exploration Company, LLC* is a great reminder of this. The *Sklar Exploration* decision shows how important it is for creditors to be armed with sufficient evidence if they intend to rebut the insolvency and "greater-than-Chapter 7 recovery" elements of a preference claim, and for creditors to also conduct the necessary fact investigation to prove any potential affirmative defenses.

Preference Claims: The Elements and Burden of Proof

Section 547 of the Bankruptcy Code establishes a statutory cause of action by a debtor, trustee or other estate fiduciary in a bankruptcy case to recover, as a "preference," certain transfers by a debtor to a creditor before the bankruptcy filing. The preference statute is to supposed to promote fairness by enabling an estate fiduciary to redistribute preference recoveries among all similarly classified creditors under the priority scheme of the Bankruptcy Code. Unfortunately, this does not occur in many bankruptcy cases, where preference recoveries from unsecured trade creditors are used to pay higher priority claims (such as secured or administrative expense claims). Regardless, any creditor that has been hit with a preference claim likely does not find it fair to turn prepetition payments over to *anyone*.

An estate fiduciary (often a liquidating trustee, as was the case in *Sklar Exploration*) must prove all of the following to avoid and recover a pre-petition transfer as a "preference":

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 (such as an outstanding invoice);
4. Within he 90 days before the bankruptcy filing (or within a year before

the filing, if the transfer was to an "insider");

5. When the debtor was insolvent on a balance sheet basis (liabilities exceeding assets); and
6. The transfer enabled the creditor to receive more than it would in a hypothetical Chapter 7 bankruptcy case (the "greater-than-Chapter 7 recovery" element) as of the bankruptcy filing date.

The plaintiff bears the burden of proving each of these elements, with one exception: the Bankruptcy Code presumes a debtor's insolvency during the 90 days before a bankruptcy filing. A trustee does not have to present any proof of the debtor's insolvency and the burden shifts to the creditor to rebut the presumption of insolvency by providing some evidence of the debtor's *solvency* during the 90-day preference period. In addition, as illustrated by the *Sklar Exploration* decision, a trustee usually satisfies the greater-than-Chapter 7 recovery element by simply showing that the debtor's unsecured creditors will be receiving less than a 100% distribution on their prepetition unsecured claims. This is the typical scenario in most Chapter 7 bankruptcies, which yield little or no distribution to unsecured creditors.

The Bankruptcy Code provides creditors with affirmative defenses to minimize or eliminate preference liability even where the plaintiff has proven the elements of a preference claim. The preference defenses are intended to encourage creditors to continue doing business with, and extending credit to, financially distressed companies. The *Sklar Exploration* decision shows the importance of conducting the necessary fact review to prove one or more of the preference defenses. Particularly, the *Sklar Exploration* decision focused on the ordinary course of business (OCB) defense, which applies where:

1. The preference payment satisfied a debt incurred by the debtor in the ordinary course of business between the parties, and
2. The payment was made either:
   a. in the ordinary course of business or financial affairs between the parties (the "subjective" prong of the OCB defense), *or*
   b. according to ordinary business terms (the "objective" prong of the OCB defense).

The Facts

The debtor, Sklar Exploration Company, LLC—an independent exploration and production company in the oil and gas industries—filed a voluntary Chapter 11 bankruptcy petition and obtained confirmation of a Chapter 11 plan under which a liquidating trustee was appointed to, among other things, commence lawsuits to recover preference claims. During the 90 days before the bankruptcy filing, the debtor had issued two checks, totaling approximately $30,000, to the defendant, White Resources, LLC, to pay outstanding invoices for chemicals the defendant had sold to the debtor. The trustee filed a complaint against the defendant seeking to avoid and recover the payments as preferences.

The liquidating trustee moved for summary judgment. The trustee argued that he had satisfied his burden of proof on each element of the preference claim. The defendant opposed summary judgment, arguing, with scant evidence, that the trustee had failed to prove two of the required elements of the preference claim. The defendant argued:

a) The trustee did not prove the debtor was insolvent when the debtor made the alleged preference payments to the defendant because the debtor "may have been solvent . . . because of the products [the defendant] had delivered to [the debtor's] wells;" and
b) The trustee did not prove the payments enabled the defendant to receive more than it otherwise would have recovered in a hypothetical Chapter 7 bankruptcy case, which argument was based on the defendant's unsubstantiated allegation that millions of dollars in cash and equipment might have been misappropriated from the debtor before, during, and after the bankruptcy filing.

The Bankruptcy Court's Ruling

The court granted partial summary judgment in the trustee's favor, holding that the trustee had proved all of the elements of the preference claim against the defendant, including both the insolvency and greater-than-Chapter 7 recovery elements. The court noted that the trustee did not have to offer *any* evidence of the debtor's insolvency when the preference payments were made in light of the statutory presumption of the debtor's insolvency throughout the 90-day preference period. Instead, the defendant had to produce some evidence to rebut the presumption of insolvency. Merely suggesting the debtor might have been solvent, without providing any evidence of solvency, did not pass muster.

On the greater-than-Chapter 7 recovery element, the court stated that ***"unless the estate is fully solvent, anything that nonpriority unsecured creditors [such as the defendant] receive during the preference period will enable them to receive more than they otherwise would from a Chapter 7 distribution alone."***[1] To illustrate this point, the court created a hypothetical balance sheet for a Chapter 7 case where, after paying off a bank's secured claim, a hypothetical debtor had $300,000 in assets available to distribute to 100 unsecured creditors asserting general unsecured claims totaling $5 million, resulting in a 6% distribution. If the debtor had paid $50,000 to an unsecured creditor during the preference period and a trustee then recovered $50,000 from that creditor as a preference, the debtor would then have had $350,000 in assets available to distribute to 101 unsecured creditors asserting claims totaling $5,050,000 (the initial $5 million, plus the $50,000 general unsecured claim of the preferred creditor for the payments recovered from the creditor as a preference), resulting in an approximately 7% distribution to unsecured creditors. Clearly, the recovery in the hypothetical Chapter 7 is far less than the 100% recovery the creditor received from the $50,000 preference payment.

In the *Sklar Exploration* case—where the defendant received a 100% recovery from the payments made during the 90-day preference period—the trustee pointed to the Schedules of Assets and Liabilities filed by the debtor in its bankruptcy case. According to the schedules, the debtor had approximately $10 million in assets, and owed nearly $23 million to a bank holding a blanket lien on all of the debtor's assets. As such, the debtor's unsecured creditors likely would not have received any recovery in any hypothetical Chapter 7 case. And in the unlikely event the trustee had recovered additional assets to fund a recovery to unsecured creditors, the distribution would have likely been de minimis since the general unsecured claims pool, including the bank's deficiency claim, was approximately $34.5 million. Bottom line, the defendant was clearly better off receiving the preference payments than a hypothetical Chapter 7 recovery.

As a result, the court entered judgment in the trustee's favor on the preference claim, with the only remaining issue for trial being whether the defendant could prove the subjective OCB defense.[2]

Conclusion

A creditor seeking to rebut a preference claim must be prepared to present sufficient evidence to support its position. As illustrated by the *Sklar Exploration* decision, this can be very difficult, particularly with respect to the greater-than-Chapter 7 recovery and insolvency requirements. Regardless, creditors should be encouraged to raise every argument they reasonably can when faced with a preference demand letter or complaint—each argument may hold some value as leverage in settlement negotiations with the other side. That is particularly the case where the debtor's schedules suggest the debtor's solvency with assets exceeding liabilities.

And, creditors should not stop at rebutting the trustee's proof of a preference claim. Creditors should roll up their sleeves and conduct the necessary investigation to assess their OCB defense (as well as their subsequent new value defense for all new credit extended to the debtor during the preference period after receipt of any alleged preference payment). In most cases, the defenses are the most powerful arrows in a creditor's quiver.

1 The defendant in the *Sklar Exploration* case was a nonpriority unsecured creditor. The court noted that a fully secured creditor and a priority creditor entitled to a 100% recovery on their claims should be able to rebut the greater-than-Chapter 7 recovery element of a preference claim because the creditors would be no better off receiving the preference payment than they would have been in a hypothetical Chapter 7 case where they would have recovered 100% of their claims.

2 The defendant asserted the alleged preference payments were made in the ordinary course of business and, therefore, should have been subject to a full OCB defense. However, the court held that the defendant had presented insufficient evidence to prevail on the subjective OCB defense because defendant had failed to prove any consistency in the timing of the payments or the parties' patterns and practices before and during the preference period, and reserved the issue for trial. Also, the court noted that the defendant had failed to satisfy the objective OCB defense where the alleged preference payments satisfied defendant's invoices that were outstanding for 120 and 160 days while the defendant's other customers had paid invoices that were outstanding in the range of 30-45 days.