

I Have My First Preference Claim....What Do I Do Now?

By:
Lynette R. Warman
Hunton & Williams LLP
1445 Ross Avenue, Suite 3700
Dallas, Texas 75202
(214) 468-3393
www.hunton.com
lwarman@hunton.com
Copyright 2009

Top 4 things not to do:

- Do not ignore a preference demand from a trustee
- Do not ignore a lawsuit
- Do not automatically pay the amounts demanded
- Do not delegate the matter to an uninformed subordinate

Best things to do:

- Figure out if you have any exposure
- Talk to a lawyer
- Figure out a strategy
- Don't miss deadlines
- Learn about how to defend yourself

Preferential Transfers – Overview, Policy and Purpose

- Bankruptcy statute allows Trustee or Debtor-in-Possession in bankruptcy to recover certain transfers made to creditors immediately prior to the bankruptcy filing
- Provides for fair and equal treatment of all Unsecured Creditors
- Prevents Debtor from paying “preferred” creditors immediately prior to filing bankruptcy

How do you do the right things?

- Let’s start today by learning the basics.
- What is a preference?
- Why does it exist?
- What are the defenses?
- What are some best practices to follow?

What is a preference?

A Trustee in bankruptcy may avoid transfers of a debtor’s interest in property that:

- Were made to or for the benefit of a creditor
- Were made for or on account of an antecedent debt
- Were made while debtor was insolvent
- Were made –
 - On or within 90 days before the petition was filed; or,
 - If the creditor is an *insider*, on or within 1 year before the petition was filed; **AND,**

11 U.S.C. § 547(b) - continued

- Enabled the creditor to receive more than the creditor would have received if:
 - The case were a case under Chapter 7 of the Bankruptcy Code;
 - The transfer had not been made; and,
 - The creditor received payment of such debt to the extent provided by the provisions of Chapter 7
- Trustee **must prove all 5** elements to recover transfer
- Intent of Debtor and the creditor is irrelevant

Process for Recovery of Preferential Transfers

- Usually Trustee sends demand for turnover to creditor
- If no response from demand, Trustee will initiate litigation by filing a Complaint and serving it upon creditor—usually by mail
- Answer to Complaint due within 30 days of date of summons
- Typically, Trustee will engage in settlement discussions prior to Answer deadline

What Can Be Recovered?

- A Transfer
- Transfer is broadly defined:
 - Cash or cash equivalents or other property of the debtor are included (including returned merchandise and other merchandise and other transfers of value)

Transfers Must Be Made To or For The Benefit of a Creditor

- Creditor: Entity with a claim against the debtor that arose on or before a bankruptcy petition filing

For or On Account of Antecedent Debt:

- Antecedent debt: a debt existing before the transfer was made (i.e., pre-existing debt)
- Cash on Delivery (COD), Cash on Order (COO) or prepaid account terms are not payments on account of antecedent debt. Therefore, there can be no preferential transfer.

CAUTION: Apply COD or COO payments to current delivery, not outstanding invoices.

Debtor Must be Insolvent When Transfer is Made:

- Insolvent – Debtor’s liabilities exceed its assets (balance sheet test)
- Debtor is presumed insolvent within 90 days prior to bankruptcy

Transfer Made Within 90 Days Prior to Bankruptcy (unless Insider, then 1 year)

- Cash transfer – transfer occurs when payment is made
- Check – transfer is made when check clears the debtor's bank and can no longer be stopped or returned.

How do you Defeat Preference Claims?

- Statutory elements cannot be proven
- Affirmative Defenses

Transfer Does Not Satisfy Statutory Elements

- A. Payment did not come from debtor – i.e., payment from guarantor or third party. This is not a transfer from debtor
- B. Payment was not made on account of antecedent debt
 - Cash in advance
 - Cash on delivery
- C. Debtor was not insolvent at time of transfer

CAUTION: Do not apply COD or CBD payment to previous balances, but to current delivery invoice.

Affirmative Defenses

- Contemporaneous Exchange for Value
- Ordinary Course of Business
- Subsequent New Value

Contemporaneous Exchange for Value

- Parties must both intend that exchange is contemporaneous, (i.e., Cash on delivery)

Ordinary Course of Business Must Show:

- Debt was incurred by the debtor in the ordinary course of business between debtor and transferee/creditor; **AND**
 - Payment was made in the ordinary course of business of the debtor and transferee/creditor;
 - Look at payment history
- OR**
- Payment was made according to ordinary business terms used in the industry in which the debtor and transferee/creditor operate.
 - Fact-intensive defense
 - Expensive to prove
 - Good record keeping helps

Subsequent New Value

- Rewards creditors who continue to do business and extend credit terms to the debtor
- Creditors shipping debtor additional inventory or otherwise extending additional credit after receiving preferential transfer are entitled to credit for new value shipped or credit extended
- Subsequent new value may not be paid by "otherwise unavoidable transfer"
- Keep good records
- Different methods to measure amount of new value

Best Practices regarding Preference Actions

When you suspect a debtor is in financial difficulty:

- Apply payments to most recent invoices (preserves ordinary course of business defense)
- Terms: Cash on Delivery or Cash before delivery
- Avoid post-dated checks
- Accurate record keeping and consistent policies

Other tips

- Respond to preference demands timely. Try to work it out before litigation.
- If you are required to turn over preferential transfer, file a proof of claim for amount turned over.

Thank You

- This ends the module
