There are options to reduce or eliminate a preference exposure

By Scott A. Wolfson, Esq.

It is often unpleasant to receive a call from your client after it receives a preference demand letter, especially if this is the client's first experience with bankruptcy preference laws.

The process usually starts with a letter from bankrupt BrokeCo. that essentially reads:

"Dear Trade Vendor: Remember us? We are the company that stiffed you for $100,000 two years ago when we filed for bankruptcy. We know you understand, because the economy has been terrible.

"We are now writing to demand that you turn over the $75,000 we paid you 90 days before our bankruptcy filing because that payment constitutes a 'preference' under the Bankruptcy Code.

"But, don't worry — if you pay within the next 14 days, we will take $71,250 in full settlement. Please make the check payable to ..."

"They are adding insult to injury" is something I have heard on many occasions. Writing a check for the full amount demanded is rarely advisable because the client will often have defenses to reduce, if not eliminate, its preference exposure.

So, what is the policy reason for this law?

Preferences are payments that favor certain creditors over others. It often seems unfair to clients when they are sued by a company for the return of payments they received when the company still owes them substantial sums.

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One of the primary purposes of the bankruptcy preference law is to ensure that creditors who were paid within 90 days of the bankruptcy were not "preferred" over other creditors.

For example, if BrokeCo. had only two creditors and $75,000 in its bank account shortly before it filed for bankruptcy, paid your client $75,000 and BrokeCo.'s other creditor nothing, your client was clearly preferred over the other creditor.

In this case, it would seem equitable for the $75,000 payment to be returned and each creditor to be paid $37,500. However, the unfairness of a preferential payment is rarely this clear-cut.

The Bankruptcy Code's (11 U.S.C. 547(b)) definition of a preference is, a debtor, or the trustee of a debtor, may avoid any transfer of an interest of the debtor in property:

• To or for the benefit of a creditor;

• For or on account of an antecedent debt owed by the debtor before such transfer was made;

• Made while the debtor was insolvent;

• Made on or within 90 days before the date of the filing of the petition; or between 90 days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider; and

• That enables such creditor to receive more than such creditor would receive if (A) the case were a case under chapter 7 of this title; (B) the transfer had not been made; and (C) such creditor received payment of such debt to the extent provided by the provisions of this title.

Outside the confines of bankruptcy, a company is generally free to pay its creditors in any order of priority. However, if the company were to subsequently file for bankruptcy, transfers meeting the elements set forth above may be set aside.

A preferential payment that is avoided becomes part of the common pool of assets, known as the "bankruptcy estate," for distribution to creditors under the Bankruptcy Code's priority scheme.

In the legislative history to the preference provision, Congress described the purpose of the preference-avoidance power as twofold: first, to discourage creditors from racing to the courthouse to dismember the debtor during its slide into bankruptcy; and second, to facilitate the prime bankruptcy policy of equality of distribution among creditors of the debtor.

Thus, if the $75,000 payment by BrokeCo. to your client constituted a

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preference, the debtor could recover the $75,000 for distribution pro rata to BrokeCo.'s creditors.

There are defenses to preferences.

Section 547(c) of the Bankruptcy Code excepts certain transfers from being avoided as preferences even though they meet the elements of a preference under section 547(b). The exceptions include payments in the ordinary course of business; contemporaneous exchanges for new value; purchase money security interests, or "enabling loans"; and preferences subsequently offset by unsecured credit, or "new value."

The most common preference defense is the ordinary course of business defense. The legislative history behind the ordinary course of business defense states that its purpose is to leave undisturbed normal financing relations because it does not detract from the general policy of the preference section to discourage unusual action by either the debtor or its creditors during the debtor's slide into bankruptcy.

The defense provides that a transfer may not be avoided to the extent that such transfer was in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee, and such transfer was:

- Made in the ordinary course of business or financial affairs of the debtor and the transferee; or
- Made according to ordinary business terms.

Courts have interpreted the requirements of the former to be a subjective test, i.e., that the transfer be ordinary in relation to the other business dealings between that creditor and that debtor. And, courts have interpreted the requirements of the latter to be an objective test, i.e., that the transfer be ordinary in relation to the prevailing standards in the relevant industry.

This allows for a two-pronged ordinary course defense approach, first focusing on transactions ordinary between the debtor and the transferee, and, second, using the objective/industry ordinary course defense to protect any transfers not subjectively ordinary between the parties.

Writing a check in response to preference demand letter is almost never advisable. A preference analysis by a seasoned bankruptcy practitioner should be performed to determine the nature and extent of the client's defenses, including under the ordinary course of business.

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