Preference Litigation
What is a preference?

• A preference is a payment made by an insolvent debtor that favors certain creditors over others.

• The causes of action to avoid and recover preferential payments are codified in 11 U.S.C. §§ 547(b) and 550(a).
Purposes of the Preference Statute

• Discourages creditors from racing to the courthouse to dismember the debtor during debtor’s slide into bankruptcy

• Facilitates the prime bankruptcy policy of equality of distribution among creditors of the debtor
Elements of Section 547(b)

A trustee may avoid any transfer of an interest of the debtor in property—

• (1) to or for the benefit of a creditor;

• (2) for or on account of an antecedent debt owed by the debtor before such transfer was made;

• (3) made while the debtor was insolvent;

• (4) made—
  • (A) on or within 90 days before the date of the filing of the petition; or
  • (B) between ninety 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

• (5) that enables such creditor to receive more than such creditor would have received in a Chapter 7 liquidation.
Debtor’s Interest in Property

• Defined: Property that would have been part of the estate had it not been transferred before the commencement of bankruptcy proceedings.¹

• Money paid from a commingled bank account under the debtor’s control is presumptively the debtor’s property.²

• Consignment goods are usually considered to be the debtor’s property.³

¹ Beiger v. I.R.S., 496 U.S. 53 (1990)

² In re Bullion Reserve of N. Am., 836 F.2d 1214 (9th Cir. 1988)

Debtor’s Interest in Property

• Available credit is an interest of the debtor in property.¹

• When making a purchase by credit card, both the credit card company and the vendor can be recipients of preferential transfers from a debtor.

  • The credit card company will be a recipient of a preferential transfer if the debtor makes a payment on its credit card bill.

  • The vendor will be a recipient of a preferential transfer because the debtor chose to use its available credit to pay that particular vendor instead of distributing the funds among all of the debtor’s creditors.²

---

¹ In re Marshall, 550 F.3d 1251 (10th Cir. 2008).

² In re Werner, 365 B.R. 283, 284 (Bankr. M.D.Ga. 2007)
No Interest of Debtor In Property

• Property held in trust by the debtor for the benefit of another is not property of the estate. However, if trust funds are commingled with other funds, the proponent of the trust has the burden of tracing and identifying the trust funds.¹

• “Earmarked” Property: When a third party loans money to a debtor for the sole purpose of repaying a specific debt to a specific creditor, the money never becomes property of the debtor’s estate.²

*Example:* A bank made a loan to a debtor to satisfy subcontractors' liens on the debtor’s property. The loan was secured by a second mortgage on the debtor’s property. The bank paid the funds directly to the subcontractors. Due to an oversight, the second mortgage was perfected during the preference period. Under these circumstances, the earmarking doctrine protected the second mortgage from avoidance.³


² *McCuskey v. National Bank of Waterloo (In re Bohlen Enters., Ltd.), 859 F.2d 561* (8th Cir. 1988)

³ *Kaler v. Community First National Bank (In re Heitkamp), 137 F.3d 1087* (8th Cir. 1998)
To or For the Benefit of a Creditor

• When a debtor borrows funds from a lender, and subsequently, the lender assigns its right to payment to third party, the debtor’s payment to the third party is for the benefit of a creditor.¹

• When a Ponzi scheme debtor received funds from an investor for the purchase of bullion, the investor became a creditor because he accrued a right to demand bullion from the debtor. Although this right was not mature, it still constituted a claim under the Bankruptcy Code.²

• Even a buyer of goods from a debtor can become a creditor of the debtor. For example, if a debtor ships non-conforming goods and subsequently refunds the buyer’s payment for those goods, the refund constitutes a payment made to or for the benefit of a creditor.³

¹ In re Cardon Realty Corp., 146 B.R. 72, 79 (Bankr. W.D.N.Y. 1992)

² In re Bullion Reserve of N. Am., 836 F.2d 1214 (9th Cir. 1988)

³ In re Cybermech, Inc., 13 F.3d 818 (4th Cir. 1994)
On Account of an Antecedent Debt

- A debt is “antecedent” if it was incurred before the allegedly preferential transfer.\(^1\)

- Prepayments cannot be avoided because they are not made on account of an antecedent debt. In other words, there was no debt owed at the time of the payment.\(^2\)

---

\(^1\) *Jones Truck Lines, Inc. v. Cent. States, S.E. & S.W. Areas Pension Fund (In re Jones Truck Lines, Inc.)*, 130 F.3d 323 (8th Cir. 1997)

When is the Debt Incurred?

**GOODS**

- Depending upon the parties’ contract terms, the debt is incurred on the delivery date or the shipment date.\(^1\)

**SERVICES**

- The debt is incurred on the date that the services are rendered.\(^2\)

---

\(^1\) *In re Furrs Supermarkets, Inc.*, 296 B.R. 33 (Bankr. D.N.M. 2003)

\(^2\) *In re First Jersey Sec., Inc.*, 180 F.3d 504 (3d Cir. 1999)
Made When the Debtor is Insolvent

- Under 11 U.S.C. § 101(32), insolvent means that the sum of the debtor’s debts is greater than all of the debtor’s property, at a fair valuation.

- 11 U.S.C. § 547(f) provides a rebuttable presumption that the debtor was insolvent on or during the 90 days immediately preceding the petition date.
90 Day v. 1 Year Preference Period

90 Day Preference Period
• Defendant can be anyone whose dealings with the debtor are at arm’s length.
• Plaintiff is entitled to statutory presumption of insolvency.

1 Year Preference Period
• Defendant must be an insider of the debtor.
  • Examples: Relatives, general partners, directors, officers, control persons, affiliates, and managers
• Plaintiff is not entitled to statutory presumption of insolvency.
Creditor Receives More Than It Would Have Received in a Chapter 7 Case

• Unless the debtor’s estate has sufficient funds to provide a 100% distribution, any unsecured creditor that received a payment during the preference period received more than it would have received under a Chapter 7 liquidation.¹

• General unsecured creditors cannot return the difference between the preferential payment and the amount that they would have received in a Chapter 7 liquidation because the total amount of their distribution will not be known until the debtor’s bankruptcy case is closed.

• Payments to fully secured creditors are not preferential because the creditors would be entitled to full payment in a Chapter 7 liquidation.²

• Payments to undersecured creditors are preferential to the extent that such payments are applied to the unsecured portions of debt.³

¹ *In re Chattanooga Wholesale Antiques, Inc.*, 930 F.2d 458 (6th Cir. 1991)

² *In re Powerine Oil Co.*, 59 F.3d 969 (9th Cir. 1995)

³ *In re El Paso Refinery, L P*, 171 F.3d 249 (5th Cir. 1999)
Recovery of Preferential Transfers

• Under 11 U.S.C. § 550(a), a trustee can recover a preferential transfer from an initial transferee or an entity for whose benefit such transfer was made.

• Factoring Agreement Scenario: Creditor A sells goods to Debtor on account. Subsequently, Creditor A enters into a factoring agreement with Creditor B whereby Creditor A sells or assigns its accounts receivable from Debtor to Creditor B. The trustee may bring a preference action against Creditor B as the initial transferee and Creditor A as the entity for whose benefit such transfer was made.¹

• Mere Conduit Defense: A transfer will not be avoidable if a defendant can establish that: 1) it lacked dominion and control over the transfer because the funds simply passed through its hands; and 2) that it had no power to redirect the funds to its own use.² Generally, "mere conduits" are parties who hold transferred funds via escrow, trust, or deposit, and do so only in the status of commercial or professional intermediaries for parties that actually hold or receive a legal right, title, or interest.³

• Example: A law firm that received funds from a debtor in settlement of a client's lawsuit, and subsequently transferred those funds to its client was a mere conduit for those funds and not an initial transferee.⁴

³ In re Bauer, 318 B.R. 697 (Bankr. D.Minn. 2005)
Preferences and Section 502(d)

- Under 11 U.S.C. § 502(d), courts must disallow any claim of any entity from which property is recoverable under Section 550 or that is a transferee of an avoidable transfer under Section 547, unless such entity or transferee has paid the amount, or turned over any such property.

- Section 502 was intended to preclude entities that have received voidable transfers from sharing in the distribution of assets unless and until the voidable transfer has been returned to the estate.\(^1\)

- Even if a creditor’s claim is $1 million and the preferential payment is $100, the entire creditor’s claim will be disallowed unless the creditor repays the preferential payment to the debtor’s estate.\(^2\)

---


Statutory Defenses to Preference Actions

• 11 U.S.C. § 547(c)(1) – Contemporaneous Exchange

• 11 U.S.C. § 547(c)(2) – Ordinary Course of Business

• 11 U.S.C. § 547(c)(4) – Subsequent New Value
Contemporaneous Exchange

To order to prevail on a contemporaneous exchange defense, a defendant must prove that:

1) Both parties intended the transfer to be a contemporaneous exchange for new value; 2) the exchange was, in fact, contemporaneous; and 3) the creditor, in fact, gave new value to the debtor.¹

Intent is the key! Even if the time between the payment and new value was minimal, the defense is not applicable if the parties intended that the payment be made in satisfaction of outstanding debt.²

Example: As a result of a debtor’s past-due account, a supplier changed the parties’ payment terms to require the debtor to pay immediately upon receipt of shipments. During the preference period, the supplier shipped goods and the debtor immediately paid. However, as the evidence reflected that the supplier applied the payment to the debtor’s past-due account, the supplier was not entitled to a contemporaneous exchange for new value defense.³

² Creditors’ Committee v. Spada (In re Spada), 903 F.2d 971 (3d Cir. 1990)
Ordinary Course of Business

• Purpose of Exception

  • Leaves normal financial relations undisturbed
  
  • Protects payments that do not result from unusual debt collection or payment practices

• In order to prevail on an ordinary course of business defense, a defendant must prove that the transfer was either:

  • made in the ordinary course of business or financial affairs of the debtor and the transferee (Subjective Prong) or

  • made according to ordinary business terms (Objective Prong).
Section 547(c)(2)(A) Subjective Prong

• Comparison of parties’ relationship during the 90 days prior to the petition date (the “Preference Period”) to the time period before the Preference Period (the “Historical Period”)

• The greater the deviation in payment time from the Historical Period, the less likely a defendant will be able to satisfy the subjective prong.
Subjective Prong: Relevant Factors

- Timing of the transaction or payment
- Length of time the parties engaged in the type of dealing at issue
- Whether transfer was in an amount more than usually paid
- Whether payments were tendered in a manner different from previous payments
  - Examples: Changing payment method from check to wire, paying multiple invoices at once
- Whether there was any unusual action by either the debtor or creditor to collect or pay on the debt
- Whether the creditor did anything to gain an advantage in light of the debtor’s deteriorating financial condition
  - Examples: Threats of lawsuits, refusals to ship additional goods until payment is made
Subjective Prong: Range v. Average Comparison

RANGE METHOD

• Using the historical period data, take the lowest and highest number of days from invoice date to payment date to get the range. Any payment during the preference period that falls within that range is ordinary.

AVERAGE METHOD (Preferred)

• Compare the average time of payment after the issuance of an invoice during the Historical and Preference Periods. To determine which payments are ordinary, review the range of payments centered around the Historical Period average and also groups the payments in buckets by age.


2 In re Quebecor World (USA), Inc., 2013 WL 1741946 (Bankr. S.D.N.Y. Apr. 23, 2013)
Age Bucket Analysis Chart

### Aging Analysis Comparing Pref Period To Historical Period

- **Period:** From 10/26/2005 To 10/22/2007
- **Days:** 726
- **Net of NV:** $1,000,000.00
- **Transfer:** $155,130.05
- **New Value:** $35,766.00
- **New Net:** $111,370.05

### Data Sources
- **A:** Aging categories summing # of invoices and $ amount of invoices paid within age category.
- **B & C:** The % of Amount Paid within each age category ($ in Category divided by Total $).
- **D:** The percentage difference between the preference period and the historical "baseline".
- **E & F:** These columns show the total # of invoices paid, and $ paid within preference and historical time periods.
- **G & H:** Columns G & H show the total paid within each age category.

### Pref Period Aging Statistics - 5 Day Intervals: All Paid Invoices - Percent of Invoices by Bucket

<table>
<thead>
<tr>
<th>Age Bucket</th>
<th>Pref Per</th>
<th>Historical</th>
<th>% Diff</th>
<th>Pref Per</th>
<th>Historical</th>
<th>Pref Per</th>
<th>Historical</th>
<th>Pref Per</th>
<th>Historical</th>
</tr>
</thead>
<tbody>
<tr>
<td>&lt;5</td>
<td>0.0%</td>
<td>0.0%</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>$155,130</td>
<td>$111,370</td>
<td>$45,760</td>
<td></td>
</tr>
<tr>
<td>5 to 10</td>
<td>0.6%</td>
<td>0.0%</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>$155,130</td>
<td>$111,370</td>
<td>$45,760</td>
<td></td>
</tr>
<tr>
<td>11 to 15</td>
<td>0.6%</td>
<td>0.0%</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>$155,130</td>
<td>$111,370</td>
<td>$45,760</td>
<td></td>
</tr>
<tr>
<td>16 to 20</td>
<td>0.6%</td>
<td>0.0%</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>$155,130</td>
<td>$111,370</td>
<td>$45,760</td>
<td></td>
</tr>
<tr>
<td>21 to 25</td>
<td>4.5%</td>
<td>22.24%</td>
<td>-79%</td>
<td>2</td>
<td>72</td>
<td>$7,150</td>
<td>$254,190</td>
<td>$247,040</td>
<td></td>
</tr>
<tr>
<td>26 to 30</td>
<td>0.6%</td>
<td>16.63%</td>
<td>-97%</td>
<td>0</td>
<td>55</td>
<td>$7,150</td>
<td>$254,190</td>
<td>$247,040</td>
<td></td>
</tr>
<tr>
<td>31 to 35</td>
<td>0.6%</td>
<td>13.14%</td>
<td>-97%</td>
<td>0</td>
<td>46</td>
<td>$7,150</td>
<td>$254,190</td>
<td>$247,040</td>
<td></td>
</tr>
<tr>
<td>36 to 40</td>
<td>17.91%</td>
<td>6.93%</td>
<td>157%</td>
<td>8</td>
<td>23</td>
<td>$7,150</td>
<td>$254,190</td>
<td>$247,040</td>
<td></td>
</tr>
<tr>
<td>41 to 45</td>
<td>2.43%</td>
<td>4.76%</td>
<td>-49%</td>
<td>1</td>
<td>18</td>
<td>$7,150</td>
<td>$254,190</td>
<td>$247,040</td>
<td></td>
</tr>
<tr>
<td>46 to 50</td>
<td>29.92%</td>
<td>5.09%</td>
<td>498%</td>
<td>14</td>
<td>17</td>
<td>$7,150</td>
<td>$254,190</td>
<td>$247,040</td>
<td></td>
</tr>
<tr>
<td>51 to 55</td>
<td>8.84%</td>
<td>1.15%</td>
<td>647%</td>
<td>4</td>
<td>4</td>
<td>$7,150</td>
<td>$254,190</td>
<td>$247,040</td>
<td></td>
</tr>
<tr>
<td>56 to 60</td>
<td>26.54%</td>
<td>11.5%</td>
<td>1256%</td>
<td>12</td>
<td>4</td>
<td>$7,150</td>
<td>$254,190</td>
<td>$247,040</td>
<td></td>
</tr>
<tr>
<td>61 to 65</td>
<td>0.6%</td>
<td>0.0%</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>$7,150</td>
<td>$254,190</td>
<td>$247,040</td>
<td></td>
</tr>
<tr>
<td>66 to 70</td>
<td>0.6%</td>
<td>0.0%</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>$7,150</td>
<td>$254,190</td>
<td>$247,040</td>
<td></td>
</tr>
<tr>
<td>71 to 75</td>
<td>0.6%</td>
<td>0.0%</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>$7,150</td>
<td>$254,190</td>
<td>$247,040</td>
<td></td>
</tr>
<tr>
<td>76 to 80</td>
<td>0.6%</td>
<td>0.0%</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>$7,150</td>
<td>$254,190</td>
<td>$247,040</td>
<td></td>
</tr>
<tr>
<td>81 to 85</td>
<td>0.6%</td>
<td>0.0%</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>$7,150</td>
<td>$254,190</td>
<td>$247,040</td>
<td></td>
</tr>
<tr>
<td>86 to 90</td>
<td>2.12%</td>
<td>0.00%</td>
<td>0</td>
<td>1</td>
<td>0</td>
<td>$7,150</td>
<td>$254,190</td>
<td>$247,040</td>
<td></td>
</tr>
<tr>
<td>91 to 95</td>
<td>0.6%</td>
<td>0.28%</td>
<td>0</td>
<td>1</td>
<td>0</td>
<td>$7,150</td>
<td>$254,190</td>
<td>$247,040</td>
<td></td>
</tr>
<tr>
<td>96 to 100</td>
<td>4.65%</td>
<td>0.00%</td>
<td>0</td>
<td>2</td>
<td>0</td>
<td>$7,150</td>
<td>$254,190</td>
<td>$247,040</td>
<td></td>
</tr>
<tr>
<td>Over 100</td>
<td>4.20%</td>
<td>0.00%</td>
<td>0</td>
<td>2</td>
<td>0</td>
<td>$7,150</td>
<td>$254,190</td>
<td>$247,040</td>
<td></td>
</tr>
</tbody>
</table>

### Comparison of Average Invoice to Delivery Between Historical Baseline & Preference Period

<table>
<thead>
<tr>
<th>Age Method</th>
<th>Pref Period</th>
<th>Prior Hist</th>
<th>Diff by</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Wavg</td>
<td>Wavg</td>
<td>Wavg</td>
</tr>
<tr>
<td>all hist</td>
<td>57.56</td>
<td>27.56</td>
<td>10%</td>
</tr>
</tbody>
</table>

### By % of Dollar Amount of Invoices

- **Above:** 50%
- **Below:** 50%

<table>
<thead>
<tr>
<th>Category</th>
<th>Pref Period</th>
<th>Historical</th>
<th>% Diff</th>
</tr>
</thead>
<tbody>
<tr>
<td>Over 5</td>
<td>22%</td>
<td>88%</td>
<td>-74%</td>
</tr>
<tr>
<td>Below</td>
<td>78%</td>
<td>12%</td>
<td>522%</td>
</tr>
</tbody>
</table>

This document was prepared to further settle discussions. Consequently, Rule 408 of the Federal Rules of Evidence applies and neither this document nor any of its contents may be introduced as evidence.
Subjective Prong: Weighted Average Method

• The weighted average is calculated by multiplying the amount of the invoice by the days it took to get paid and then dividing that value by the total amount of the invoices in the data set.¹

• As the weighted average takes into account the relative invoice amount and generates an average based on the days to payment and the amount of payments, it may be a more comprehensive method than the straight average method.

Subjective Prong: Choosing the Relevant Historical Period

• The following choices, based on what produces the best outcome for the client, should be considered:

  • The 12-month prior history;
  • The 24-month prior history (“Entire History”);
  • The Entire History, after excluding the immediate 90 days prior to the start of the preference period; or
  • The Entire History, after excluding the immediate 180 days prior to the start of the preference period.
Subjective Prong: Choosing the Relevant Historical Period

- Each of these date ranges should produce a different historical weighted average.

- Excluding the 90 or 180-day pre-preference transaction period is intended to foster a comparison to when the debtor was, presumably, financially healthy.

- Case law supports the view that the comparative historical baseline should be based on the time frame when the debtor was financially healthy.¹ Thus, a longer historical period is usually preferable because it is more likely to reflect the parties’ dealing when the debtor was financially healthier.²

---

¹ In re Molded Acoustical Products, Inc., 18 F.3d 217 (3d Cir. 1994); In re Meridith Hoffman Partners, 12 F.3d 1549 (10th Cir. 1993)
² In re Quebecor World (USA), Inc., 2013 WL 1741946 (Bankr. S.D.N.Y. Apr. 23, 2013)
Section 547(c)(2)(B) 
Objective Prong

• Comparison of the parties payment terms to payment terms in both the creditor’s and debtor’s industries as well as general business standards.¹

• Although the objective prong is sometimes known as the “battle of the experts,” corporate representatives and/or long term employees are also permitted to testify regarding industry credit, payment, and general business terms in order to support its position as long as the Federal Rules of Evidence are satisfied.²

² Sigma Micro Corp. v. Healthcentral.com (In re Healthcentral.com), 504 F.3d 775 (9th Cir. 2007)
Subsequent New Value

• A transfer cannot be avoided to the extent that, after such transfer, the creditor gives “new value” to the debtor:
  
  • (A) not secured by an otherwise unavoidable security interest; and
  
  • (B) on account of which new value the debtor did not make an otherwise unavoidable transfer to or for the benefit of such creditor.

• To the extent that unsecured new value is given to the debtor after a preferential transfer is made, the preference is repaid to the bankruptcy estate.\(^1\) Thus, the estate’s assets are not depleted to the disadvantage of other creditors.\(^2\)

---

\(^1\) In re Prescott, 805 F.2d 719 (7th Cir. 1986)

\(^2\) Harrah’s Tunica Corporation v. Meeks (In re Armstrong), 291 F.3d 517 (8th Cir. 2002)
Paid v. Unpaid New Value

- The language “on account of which new value the debtor did not make an otherwise unavoidable transfer to or for the benefit of such creditor” has led to two different interpretations of new value.

- Unpaid Approach: If a debtor makes a payment on new value, that new value cannot be used to avoid a prior transfer.
  - Example: A debtor makes a payment of $100 to a creditor. Then, the creditor sends $150 of new value to the debtor followed by the debtor’s payment of $150 on that new value. Under the unpaid approach, the creditor’s $150 of new value cannot be used to offset the debtor’s $100 payment. This is because the $150 of new value was paid by the debtor.

- Paid Approach: If a debtor makes a payment on new value, that new value may be used to avoid a prior transfer to the extent that the payment on the new value is not an unavoidable transfer.
  - Example: Same facts as above. Under the paid approach, the creditor’s $150 of new value can be used to offset the debtor’s $100 payment if the debtor’s $150 payment was not made in the ordinary course of the parties business. Conversely, the new value cannot be used to offset the debtor’s $100 payment if the debtor’s $150 payment was made in the ordinary course of the parties business.
# Unpaid New Value Calculation

<table>
<thead>
<tr>
<th>Transaction Date</th>
<th>Transaction Type</th>
<th>Transaction Amount</th>
<th>Allowed New Value</th>
<th>Net Preference Claim</th>
</tr>
</thead>
<tbody>
<tr>
<td>5/1/2013</td>
<td>Check</td>
<td>$1,000.00</td>
<td></td>
<td>$1,000.00</td>
</tr>
<tr>
<td>5/15/2013</td>
<td>Invoice</td>
<td>$1,000.00</td>
<td>$0.00</td>
<td>$1,000.00</td>
</tr>
<tr>
<td>5/30/2013</td>
<td>Check</td>
<td>$1,000.00</td>
<td></td>
<td>$2,000.00</td>
</tr>
<tr>
<td>6/15/2013</td>
<td>Invoice</td>
<td>$1,000.00</td>
<td>$0.00</td>
<td>$2,000.00</td>
</tr>
<tr>
<td>6/30/2013</td>
<td>Check</td>
<td>$1,000.00</td>
<td></td>
<td>$3,000.00</td>
</tr>
<tr>
<td>7/15/2013</td>
<td>Invoice</td>
<td>$1,000.00</td>
<td>$1,000.00</td>
<td>$2,000.00</td>
</tr>
</tbody>
</table>

1. The new value amount for the 5/15/2013 invoice is $0.00 because the 5/15/2013 invoice was paid by the 5/30/2013 check.

2. The new value amount for the 6/15/2013 invoice is $0.00 because the 6/15/2013 invoice was paid by the 6/30/2013 check.

3. The new value amount of the 7/15/2013 invoice is $1,000.00 because it was not paid.
# Paid New Value Calculation

<table>
<thead>
<tr>
<th>Transaction Date</th>
<th>Transaction Type</th>
<th>Transaction Amount</th>
<th>Allowed New Value</th>
<th>Net Preference Claim</th>
</tr>
</thead>
<tbody>
<tr>
<td>5/1/2013</td>
<td>Check</td>
<td>$1,000.00</td>
<td>$1,000.00</td>
<td>$1,000.00</td>
</tr>
<tr>
<td>5/15/2013</td>
<td>Invoice</td>
<td>$1,000.00</td>
<td>$1,000.00</td>
<td>$0.00</td>
</tr>
<tr>
<td>5/30/2013</td>
<td>Check</td>
<td>$1,000.00</td>
<td>$1,000.00</td>
<td>$1,000.00</td>
</tr>
<tr>
<td>6/15/2013</td>
<td>Invoice</td>
<td>$1,000.00</td>
<td>$1,000.00</td>
<td>$0.00</td>
</tr>
<tr>
<td>6/30/2013</td>
<td>Check</td>
<td>$1,000.00</td>
<td>$1,000.00</td>
<td>$1,000.00</td>
</tr>
<tr>
<td>7/15/2013</td>
<td>Invoice</td>
<td>$1,000.00</td>
<td>$1,000.00</td>
<td>$0.00</td>
</tr>
</tbody>
</table>
Paid v. Unpaid New Value

- There is a split of authority in the seven circuits that have presided over the issue of whether new value has to remain unpaid.
  - Unpaid Approach: Third Circuit, Seventh Circuit, Eighth Circuit, Eleventh Circuit
  - Paid Approach: Fourth Circuit, Fifth Circuit, Ninth Circuit
- In recent years, even bankruptcy courts in the unpaid approach circuits have favored the paid approach.\(^1\)

Section 503(b)(9) provides administrative priority status for “the value of any goods received by the debtor within 20 days” of the petition date that were “sold to the debtor in the ordinary course of business of such debtor’s business.”

Some courts are concerned that creditors will “double dip” from the estate by making a Section 503(b)(9) administrative claim for the value of goods received within twenty days before a debtor’s filing and asserting a new value defense for those same goods in an adversary proceeding.

As of May 2013, the majority of bankruptcy courts that have presided over this issue favor disallowing double-dipping by defendants.

At least one court in favor of allowing double-dipping has reasoned that prohibiting double dipping would compel creditors to choose between exercising their rights to assert Section 503(b)(9) administrative expense claims or preserving their new value defenses. Forcing creditors to make that choice could chill their willingness to do business with troubled entities.¹

Reclamation Claims and New Value

• Reclamation (a seller’s right to reclaim goods) is a state law-based claim recognized by section 2-702(2) of the Uniform Commercial Code.

• Once a buyer files bankruptcy, Section 546(c) preserves this right but provides additional requirements that a seller must comply with to enforce its reclamation rights in the bankruptcy proceeding.

• New value given by a creditor must be reduced to reflect its reclamation claim because the new value given to the debtor prepetition must be discounted to reflect the right of reclamation preserved by Section 546(c).¹

Critical Vendor Orders

• A critical vendor motion is a first day motion whereby a debtor seeks a court order authorizing it to pay the pre-petition claims of certain vendors that the debtor deems essential to its operations.

• Courts have determined that a creditor who receives payments pursuant to a critical vendor order is not automatically shielded from preference liability for the following reasons:
  
  • The preference period payments were not made pursuant to the order.¹

  • Acceptance of the payments made under the order is voluntary.²

  • Full payment of critical vendor claims is not guaranteed.³


Pleading Standards for Preference Actions Under *Twombly* and *Iqbal*

• A complaint must contain sufficient factual matter, accepted as true, to “state a claim for relief that is plausible on its face.”¹

• Despite the new factual specificity required in pleading, courts may grant plaintiffs leave to amend complaints to include additional facts and allow the amendment to relate back to the date of filing.

Issues to Consider Prior to Filing a Preference Complaint

- In a jointly administered case, is the debtor that *paid* each transfer identified?
- In a jointly administered case, is the debtor that *incurred the debt paid for by each* transfer identified?
- Is each transfer identified by check number or identified as a wire? Is the check date and clear date listed?
- Is the actual antecedent debt identified? In many cases the invoice number and invoice date can provide this information. In other cases other documents may have to be identified to connect the transfer to antecedent debt.
  - Examples: Shipping documents, contracts
- In addition to referencing the presumption of insolvency for non-insider cases, is there other information on insolvency that may be included?
  - Example: Allegations about a debtor’s financial difficulties
- When alleging that the transfers allowed the defendant to receive more than it would have under a Chapter 7 liquidation, are there schedules and proofs of claims that can be referenced that can provide support for this element?
Statute of Limitations

• Under 11 U.S.C. § 546(a)(1), a preference action may not be commenced after the later of:

  • (A) 2 years after the entry of the order for relief; or
  • (B) 1 year after the appointment or election of the first trustee if such appointment or such election occurs before the expiration of the period specified in subparagraph (A).

• In voluntary bankruptcy cases, an order for relief arises on the petition date. In involuntary bankruptcy cases, an order for relief arises on the date that the court confirms the debtor’s bankruptcy case.
Stern v. Marshall’s Impact on Preference Actions

• In Stern, the Supreme Court held that a bankruptcy court lacked the constitutional authority to enter a final judgment on a state law counterclaim that is not resolved in the process of ruling on a creditor's proof of claim.¹

• Courts are split on the issue of whether Stern applies to preference actions in cases where the defendant has not filed a proof of claim.²

  • Courts favoring the application of Stern to preference actions have reasoned that, when a creditor who has not filed a proof of claim is sued in a preference action, it is a matter of private right that requires the exercise of the judicial power of the United States, a power that cannot be exercised by a non-Article III judge.³

  • Court disfavoring the application of Stern to preference actions have reasoned that, the public rights exception applies to preference actions, Stern does not remove the bankruptcy courts’ authority to enter final judgments on core bankruptcy matters, and the entire purpose of the preference actions is to enforce the Bankruptcy Code’s equality of distribution.⁴

¹ Stern v. Marshall, 131 S.Ct. 2594 (2011)

² In re Quebecor World (USA), Inc., 2013 WL 1721608 (Bankr. S.D.N.Y. Apr. 22, 2013)


Any Questions???

Joseph L. Steinfeld, Jr.
2600 Eagan Woods Dr.
Suite 400
St. Paul, MN 55121
Telephone: (651) 406-9665
Toll-Free: (877) 746-4275
Fax: (651) 406-9676
E-mail: jsteinfeld@askllp.com

Edward E. Neiger
151 West 46th Street
4th Floor
New York, NY 10036
Telephone: (212) 267-7342
Fax: (212) 918-3427
E-mail: eneiger@askllp.com

www.askllp.com