COMMON BUSINESS DEFENSES TO PREFERENCE CLAIMS

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One of the most troublesome provisions of the United States Bankruptcy Code for businesses is the existence of preference law that gives bankruptcy trustees and debtors-in-possession the ability to recover a wide array of payments made by the debtor business in the 90 days before it filed for bankruptcy. Preference law often has the unfortunate and seemingly random effect of adding salt to the wounds of the debtors' business partners, who are frequently left with large unpaid receivables and then find out months after the fact that they are also being sued to recover what little they might have been paid by the debtor in the days leading up to its filing. All hope is not necessarily lost, however, and businesses should understand that they have some valuable tools to defend against these actions in whole or in part, notably: 1) the 'ordinary course' defense, 2) the 'new value' defense, and 3) the 'contemporaneous exchange' defense.

Preference law is based upon 11 U.S.C. § 547 of the bankruptcy code, and it permits the recovery of certain payments and transfers made by a debtor in the days leading up to its bankruptcy. To be deemed a preference, a payment or transfer must meet the following criteria: 1) the payment or transfer is on account of an existing debt; 2) the payment or transfer occurs within 90 days prior to the bankruptcy filing (180 days for insiders of the debtor); 3) the payment or transfer occurs while the debtor is insolvent;[1] 4) and the payment or transfer allows the creditor to receive more than it would have otherwise received in a Chapter 7 case. The vast majority of preference cases involve the payment of money by way of check or wire transfer, but prefer-

ences can also take many other forms, including, but not limited to, the creation of a security interest or the leasing of property.

Ordinary Course of Business Defense: Same as It Ever Was

The ordinary course of business defense protects business transactions between a debtor and a creditor that are within the ordinary course of dealing between the parties (or within the industry). The defense is often available to entities such as trade vendors, utilities providers, and other entities providing goods or services to the debtor in the ordinary course of its business.

In order to avail itself of the defense, a creditor must show that the transfers it received during the 90-day preference period: 1) were made in payment of debts incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the creditor, and 2) were made in the ordinary course of business or financial affairs of the debtor and the creditor, or were made according to ordinary business terms.[2] In other words, if the transactions at issue looked like the transactions that occurred between the creditor and debtor prior to the 90-day preference period, the payments may be deemed to have been made in the ordinary course and protected from avoidance and recovery by the bankruptcy trustee or debtor-in-possession.[3]

The first criteria (*i.e.*, whether the debt was incurred in the ordinary course of business) is often the easier one to establish by a trade vendor, utility provider, or other entity providing goods or services to the debtor that the debtor regularly uses or re-sells in the ordinary course of the operation of its business.

In determining the second criteria (*i.e.*, whether payments were made in the ordinary course of business or financial affairs of the debtor and the creditor, or were made according to ordinary business terms) courts have considered factors such as whether the creditor engaged in unusual collection practices, whether the amount or form of payment differed from historical practice between the parties, and whether the payments made by the creditor during the 90-day preference period were later (or even earlier) than usual between the parties. This last factor, which is often litigated and is often the hardest criteria for a creditor to establish, examines the 'lag time (the amount of time between invoicing and payment) of the payments made during the 90-day preference period as compared to the 'historical' lag times of payments made prior to that period. Payments made during the preference period that are significantly later (*i.e.*, have longer average lag times or have a greater range in lag times) than those made prior to the preference period may indicate that the debtor was under financial distress, bringing the payments out of the ordinary course of business and making them vulnerable to recovery as a preference.[4]

Can a creditor do anything to protect itself from potential exposure while receiving payments from a financially distressed debtor-customer? To the extent that the creditor has leverage (*e.g.*, the debtor must continue purchasing goods or services from the creditor to stay in business), the creditor may demand that any future shipments of goods be paid C.O.D., which would bring the transaction within the requirements of the contemporaneous exchange for value defense of Section 547(c)(1), discussed below. However, creditors should be careful about imposing other demands, such as requiring shorter payment windows, in order to continue to provide goods or services to a financially distressed customer that is thought to be on the verge of bankruptcy, because a creditor's change in credit terms or credit limits during the preference period may take subsequent transfers out of the parties' ordinary course of business for preference defense purposes.[5]

Subsequent New Value Defense: High Stakes Musical Chairs

In addition to the ordinary course defense, business creditors can often utilize the subsequent new value defense as a standalone defense, or one in tandem with the ordinary course of business defense. Essentially, the bankruptcy code provides that creditors are entitled to a credit against a preference claim for any new extension of goods or services following receipt of an alleged preference payment. The new value exception, which is set forth in 11 U.S.C. § 547 (c)(4), is intended by Congress to serve as encouragement for creditors to continue working with distressed companies, and is often much easier to prove than the more subjective ordinary course defense.

In order to employ the new value defense, a creditor must be able to prove that: 1) the new value was provided to the debtor after the asserted preference payment, 2) the new value extended was not secured, and 3) the new value remains unpaid or is paid with an otherwise potentially avoidable preference.[6]

The timing of new value is critical to properly apply it as a defense. The new value must always follow the asserted preferential payment, and excess new value over that asserted preference cannot carry over and be applied to a second, later, transfer within the 90-day window. This effectively means that new value is not determined by simply adding up the alleged preference payments and deducting the new value provided. Instead, each transfer made within the 90-day window should be reduced by any subsequent new value provided, with such new value not carrying over for any additional transfer made later in the 90-day window. So if a debtor makes a payment of $10,000 to a creditor on day two of the preference

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period and then the creditor ships goods valued at $20,000 on day seven of the preference period, the $10,000 payment made on day two is fully shielded. If, however, a second payment of $15,000 is made to that same creditor on day 11 of the preference period, no amount of the $20,000 in goods provided on day seven would count as new value against the $15,000 (even though new value in excess of the first payment was previously provided). If no additional new value is provided to the debtor between day 11 and day 90, the new value defense would be inapplicable to the $15,000 transfer made on day seven.

New value, while seemingly straightforward, has been the subject of much dispute, and each element of the defense seems to have its own quirks that have been subject to varying interpretation. Examples of this include when to consider goods having been transferred for the purposes of new value and whether or not the new value must remain unpaid in order to use it as a defense. With respect to the issue of when the transfer of goods occurs, most courts have finally settled on the conclusion that the transfer takes place when the goods are shipped to the debtor,[7] rather than when they are received, even though the goods can theoretically be halted in transit to the debtor. With respect to the issue of paid versus unpaid new value, this issue is still hotly contested between and within the circuit courts of appeals. Most recently, the New Jersey Bankruptcy Court, in *In re Dots, LLC*,[8] determined that the new value defense was not limited only to unpaid invoices, and extended the new value defense to goods that were paid for with payments that were themselves avoidable.

Contemporaneous Exchange Defense: On the Count of Three

A third defense to preference claims often asserted by business defendants is set forth in Section 547(c)(1), which provides that a transfer during the 90-day period is not recoverable as a preference to the extent that the transfer was intended by the debtor and the creditor to be a contemporaneous exchange for new value given to the debtor and is, in fact, a substantially contemporaneous exchange.[9] Cash-on-delivery transactions that are truly contemporaneous exchanges should be protected from a preference claim; however, if a creditor refuses to ship goods unless a payment is made upon delivery but the creditor applies the payment to a previous invoice instead of the current shipment, a court may determine that the required intent of the parties that the transaction be a contemporaneous exchange of new value is lacking.[10]

Conclusion

For a creditor in the unenviable position of dealing with a debtor on the verge of filing for bankruptcy, life often gets worse before it gets better (*i.e.*, after not being paid for certain goods or services provided to the debtor, the creditor may later receive a notice from the trustee or debtor-in-possession demanding the return of certain payments that the debtor did make). However, the bankruptcy code provides business creditors with reasonable defenses to prevent recovery of certain transfers made during the 90-day preference period, with the goal of encouraging business entities to continue to transact with financially distressed counterparties. As discussed above, a working knowledge of these defenses may even enable the creditor to strategize its transactions and take precautions to minimize both its loss from non-payment and its potential exposure to preference liabilities. ⚖

Endnotes

1. 11 U.S.C. § 547(f) (2018) provides a rebuttable presumption that the debtor is presumed to have been insolvent on and during the 90 days immediately preceding the bankruptcy filing.
2. 11 U.S.C. § 547(c)(2).
3. Notably, “even if the debtor’s business transactions were irregular, they may be considered ‘ordinary’ for purposes of 547(c)(2) if those transactions were consistent with the course of dealings between the particular parties.” *In re Fulghum Constr. Corp.*, 872 F.2d 739, 743 (6th Cir. 1989).
4. *See, e.g.*, *Goldstein v. Starnet Capital Group LLC (In re Universal Mktg.)*, 481 B.R. 318, 329 (Bankr. E.D. Pa. 2012) (holding that a four-day difference in the average lag between the due date and receipt in comparing the payments in the preference period to the pre-preference period did not warrant avoidance of the preference period transfers).
5. *See, e.g.*, *Roberds, Inc. v. Broyhill Furniture (In re Roberds Inc.)*, 315 B.R. 443, 465-68 (Bankr. S.D. Ohio

2004); *Hechinger Inv. Co. of Delaware, Inc. v. Universal Forest Prods. (In re Hechinger Inv. Co. of Delaware, Inc.)*, 483 F.3d 568, 578 (3d Cir. 2007) (where the creditor tightened its credit terms, imposed a credit limit, and required the debtor to make payments by wire transfer in large, lump-sum amounts, the bankruptcy court did not err in finding that the new credit arrangements between the parties were "extreme" and "out of character with the long historical relationship between these parties").

6. 11 U.S.C. § 547(c)(4).
7. Generally, courts agree that the relevant date to determine when new value is given is the date of the shipment of goods. *See, e.g., In re Interstate Bakeries Corp.*, 499 B.R. 376 (Bankr. W.D. Mo. 2013); *In re Kroh Bros. Dev. Co.*, 930 F.2d 648, 651 (8th Cir. 1991); *In re Eleva, Inc.*, 235 B.R. 486 (B.A.P. 10th Cir. 1999); *In re Dots, LLC*, 562 B.R. 286 (Bankr. D.N.J. 2017).
8. *In re Dots, LLC*, 562 B.R. 286 (Bankr. D.N.J. 2017), holding, in part, that the new value defense set forth in § 547(c)(4) extended to all transfers of new value, including such transfers for which debtor made that were avoidable (*i.e.*, within the preference period). *In re Dots* noted that the often-cited case of *In re N.Y. City Shoes, Inc.* 880 F.2d 679 (3rd Cir. 1989), while referring to "'new value' which remains unpaid," was not germane to the outcome of that case and therefore *dicta*. 562 B.R. at 303. This viewpoint is not, however, uniform among the circuits and many courts will still find that the subsequent advance must be unpaid in order to count toward the new value defense. *See e.g., Levin v. Verizon Bus. Global, LLC*, 872 F.3d 526 (7th Cir. 2017).
9. 11 U.S.C. § 547(c)(1).
10. *See, e.g., Off. Comm. of Unsecured Creditors of Contempri Homes, Inc. ex rel Chapter 11 Estate of Contempri Homes, Inc. v. Seven D Wholesale (In re Contempri Homes, Inc.)*, 269 B.R. 125, 128-29 (Bankr. M.D. Pa. 2001).

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