Informational Brief Issue 8.7, September 2008

Chapter 11 - 101 The Nuts and Bolts of Chapter 11 Practice: A Primer

By Jonathan P. Friedland, Michael L. Bernstein, Prof. George W. Kuney and Prof. John D. Ayer

Preference Avoidance

Editors' Note: *This is the seveneth of 22 installments that are being published here, with permission from the American Bankruptcy Institute. The series, read consecutively, will give the reader a broad overview of the Chapter 11 bankruptcy process. The installments are chapters from a CD-Rom that is available for purchase for $20 ($10 to ABI members) through the ABI. For more information, you can call the ABI at (703) 739-0800 or go to www.abiworld.org. The authors welcome your comments and questions as well, and you may feel free to contact them. Jonathan Friedland is a member of the ABI Board of Directors as well as a member of NACM Oregon.*

We began to discuss preference avoidance in the last chapter's overview of avoidance powers. In this chapter, we discus preferences in a bit more detail. Recall that, generally speaking, Bankruptcy Code § 547 allows the debtor to avoid a transfer to a creditor for an antecedent debt, made while the debtor was insolvent, if the transfer would allow the transferee to get more than he would get in a Chapter 7.

To understand preference law, turn to § 547(b), which sets forth the *prima facie* case (subsection (a) includes a couple of definitions). If your case meets the affirmative elements of a preference under subsection (b), then you look at whether any of the exceptions, which are listed in § 547(c), apply. Then you track through the rest of the statutes (and case law) for a bunch of nuances and qualifications

Here is the *prima facie* case:

- a transfer made to or for the benefit of a creditor;
- made on account of an antecedent debt (that is, a debt that existed prior to the time of the transfer);
- made while debtor was insolvent (there is a rebuttable presumption of insolvency for the 90-day period prior to the bankruptcy filing);
- made within 90 days prior to the bankruptcy filing date, or one year if the transferee was an insider ("insider" is defined in § 101(31) of the Bankruptcy Code); and
- the transfer enabled the recipient to receive more than he would have received if the transfer had not been made and the debtor were liquidated under Chapter 7.

At the outset, notice the last requirement. It means, among other things, that transfers to fully secured or oversecured creditors are not avoidable preferences. We also think it means that a payment made for goods sold within 20 days before bankruptcy will often not be an avoidable preference, since such amounts would be paid in full (assuming administrative solvency) under § 503(a)(9).

Some examples show how preference law work:

I. Vendor supplies widgets to Debtor. Prior to the petition date, Debtor has not been paying Vendor, but Vendor—hoping the situation is temporary—continues to ship widgets. Finally, Vendor gets fed up and tells Debtor it will stop shipping if the past-due balance isn't paid immediately. Debtor pays the back-due balance, and 30 days later it files bankruptcy petition. This is likely a preference.

II. Same situation as above, but the Debtor did not file bankruptcy until 91 days after the payment to Vendor. This would not be a preference, unless Vendor were an insider, since the preference look-back period is 90 days.

III. Debtor owes unsecured debt to Lender. Lender is nervous that Debtor is insolvent and Lender fears Debtor may default on the loan. To appease Lender, Debtor grants Lender a mortgage on Debtor's headquarters building. Three weeks later, Debtor files bankruptcy. No payments involved here, but the granting of the mortgage lien is a "transfer" on account of an "antecedent debt" and therefore likely avoidable as a preference.

IV. Debtor owes Secured Lender $7 million, secured by all Debtor's real estate and accounts receivable. These security interests are properly perfected and the collateral is worth $12 million. The loan is in default and Secured Lender is threatening to foreclose, which would put Debtor out of business. So Debtor pays the $7 million and then, two days later, files bankruptcy. Sounds like it might be a preference—but probably not. Because Secured Lender is oversecured, it would be paid in full in a Chapter 7 liquidation, and so the payment it received from Debtor did not enable it to receive more than it would have received in a Chapter 7. So, no preference. The lesson: pre-petition payments to fully secured and oversecured creditors are not preferential.

These are relatively simple examples. Here are two that are a bit more complicated—but more common than you might imagine:

V. Debtor borrows $100 from Charlie and gives Charlie a security interest in Debtor's defenestrator. Debtor signs a UCC-1 financing statement, but Charlie forgets to file it in the public records. Debtor files for bankruptcy. The debtor (even though we use "debtor" throughout, this is technically wrong—it is the trustee or DIP) gets to avoid Charlie's security interest—but not as a preference. Rather, the DIP debtor avoids it using his "hypothetical lien creditor" power under § 544(a)(1). A lien creditor could have avoided this unperfected security interest at state law absent bankruptcy; the debtor steps into the shoes of the lien creditor and avoids the transfer.

VI. Debtor borrows $100 from Charlie and gives Charlie a security interest in Debtor's defenestrator. Debtor signs a UCC-1 financing statement. Charlie forgets to file it. Months pass. Charlie discovers his error and then files the financing statement. Next day, Debtor, hopelessly insolvent, files for bankruptcy. Note that the DIP cannot avoid this transfer using his lien creditor power, because he gets the rights of a lien creditor only as of the day of bankruptcy, and as of the day of bankruptcy, a lien creditor could not have avoided this (late-filed) transfer. But wait. On these facts, the Bankruptcy Code (§ 547(e)(2)) provides that the giving of security is a transfer "made" only when "perfected," *i.e.*, when it was filed. And when it was made/perfected/filed, it was a transfer for an antecedent debt. So, it is avoidable as a preference. The lesson: a late-filed security interest may be avoidable as a preference.

But that is not quite the end of it. Bankruptcy Code § 547(e) provides that a security interest is "made" when it is "perfected." But it also adds an extra fillip: a grace period for late filing. It provides that a security interest is made when it is effective between the parties if it is perfected within 30 days t thereafter. So:

VII. On Day 1, Debtor borrows $100 from Creditor, giving Creditor a security interest in his defenestrator. Debtor signs a financing statement, but Creditor forgets to file it until Day 60. No grace period: the transaction is "made" at Day 60.

VIII. Same as #1, except that Creditor files on Day 29. The grace period kicks in: the transaction is "made" at Day 1.

IX. Contrast: On Day 1, Debtor signs and Creditor files a UCC-1 financing statement. On Day 9, Debtor borrows $100 from Creditor, giving Creditor a security interest in his defenestrator. The transaction is "made" at Day 9. There is a grace period for late filing, but not for a late agreement.

There is actually a second "grace period" rule: this one is in § 547(c), the "exceptions" section. Recall: § 547(c) identifies several transactions that will not be avoidable—exceptions to the preference rules of § 547(b). It applies to the "purchase money" transactions—the case of a seller who sells goods on credit, or the lender who banks the sale. The purchase-money creditor gets 30 days to complete the perfection of his security interest. If the holder of a purchase money security interest perfects within 30 days after the debtor receives possession of the property, it will not be a preference. This section no longer dovetails with the 20-day grace period in U.C.C. § 9-317(e) as a result of its 2005 amendment.

Note that this purchase-money rule protects a seller or a lender only if there is a security interest. Without a security interest, we would expect the seller to find himself restricted to sharing with the other unsecured creditors. There is, as it happens, one thread of hope for the unsecured seller, although it is pretty thin. Bankrutpcy Code § 546(c) provides a limited right for a seller of goods to reclaim his goods from the bankruptcy estate. To do so, the seller must make a demand in writing within 45 days of the petition date. It appears that this is a federal right of reclamation that is independent of any state law right like that of U.C.C. § 2-702. However, the right is subject to senior liens on inventory, so in many cases it is likely to be ineffective. Another hope for the seller may be § 503(b)(9), new as of 2005, which provides administrative priority for goods sold to the debtor in the ordinary course of business within 20 days before the bankruptcy filing.

There are a number of other "defenses" or "exceptions" to the preference laws, in § 547(c). Any time you have a preference case, it's a good idea to go through all the § 547(c) provisions to see whether any of them might apply. We discuss a few of the more common ones below.

Section 547(c)(1) provides an exception for a "substantially contemporaneous exchange." This is easy enough to follow: the debtor takes delivery of a five-pound sack of birdseed; he passes to the seller a $5 bill. We can see why you don't want to treat this as a preferential transfer; the debtor gave as good as he got, and the estate is no worse off. Our example probably is not a preferential transfer *at all* (where's the "antecedent debt") and so not in need of an exception. But if the debt were created on day one and repaid two days later, and the parties intended the transaction to be a contemporaneous exchange, it should still qualify for the defense—even though technically the payment was for an "antecedent debt."

Another important defense is referred to as "subsequent new value." Consider this case: Debtor owes $100 to creditor, unsecured. Eighty-nine days before bankruptcy, the insolvent Debtor pays Creditor in full. This looks like a preferential transfer. But now, suppose that 88 days before bankruptcy, Creditor lends Debtor another $100. Can the Debtor avoid the payback that was made on Day PD-89 (89 days before the Petition Date) as a preferential transfer?

Bankruptcy Code § 547(c)(4) says no. It provides that we won't avoid the first transfer where the Creditor extends "new value" after it received a preferential repayment. If the new value is less than the amount of a preference payment, it does not eliminate the recipient's preference liability, but serves as an offset to the extent of the new value. There is some dispute among courts as to how subsequent new value credit should be calculated; that is beyond the scope of this general discussion, but you should review the different approaches if you have a case where this is an issue.

Another subsection of § 547(c) provide more general limitations on the power of the trustee to avoid preferential transfers. One is § 547(c)(2). It provides an exception for transfers "in the ordinary course." Consider this case: DebtorCo is deeply insolvent, just days away from bankruptcy. But, it pays all its utility bills for utility service provided the prior month when the bills for those services arrive that day—just as it always does. If DebtorCo pays—even if he pays on schedule—it looks like a payment on an antecedent debt. But if it passes the "ordinary course" test, it is not avoidable. There are slight differences in the way courts articulate the "ordinary course" test, but as a general matter if a payment is made on terms that are (1) consistent with the historical course of dealings between the debtor and creditor, or (2) on terms that are customary in the industry, they are likely to be protected by the ordinary course defense.

To explore the implications of this "ordinary course" defense, take a second look at the *prima facie* case in § 547(b), particularly § 547(b)(4) which concerns itself with the matter of timing. Bankruptcy Code § 547(b)(4)(A) provides that the DIP may avoid a preferential transfer if the transfer was made "on or within 90 days before the date of the filing of the petition." This is straightforward enough: if the debtor made the preferential transfer 91 days before bankruptcy it is unavoidable; if 89 days, then the DIP may avoid it.

Next, look at § 547(b)(4)(B). It provides a special reach-back rule if the transferee is an "insider." In the "insider" case, the trustee is not bound by the 90-day limit. To undo an otherwise preferential transfer, he can reach back as far as a year.

What is the point of this? The rule is easy enough to understand if you think of the ordinary family business, where the company president may be a shareholder, and also a creditor. As an "insider" (see the definition in § 101(31)), the president is in a position to know how bad off the debtor is. He is also in a position to decide who gets paid, and who does not. So it is not surprising that we put him on a tighter leash. But keep in mind that even in the case of an insider preference, the Bankrutpcy Code still requires that the debtor have been insolvent at the time of the transfer, and the trustee only has the benefit of the presumption of insolvency during the 90 days immediately preceding the bankruptcy filing—so the cases between 90 days and one year can sometimes be harder for the trustee to prove.

Bankruptcy Code § 547(c)(9) additionally provides a safe harbor for payees that received an aggregate of less than $5,000 in the 90-day period.

Finally, we need to consider the issue of "transferee knowledge" in preference cases. Consider this example: Debtor-Supermarket owes $100 to Butcher on a demand note. Unknown to Butcher, Debtor-Supermarket also owes $100 to Baker and $100 to Candlestick Maker. Debtor-Supermarket has only $100, with no prospect of getting more. Butcher needs some ready cash; he calls the note and demands payment. Debtor-Supermarket pays Butcher and then, 89 days later, files for bankruptcy. This sounds like an avoidable preference, and the curiosity is this: nowhere in this sketch do we suggest that the Butcher knew anything about Debtor's financial situation, or that he was trying to nose out other creditors. The point is that the DIP doesn't have to prove such transferee knowledge. It simply is not part of the *prima facie* case. This rule has always been somewhat contentious among bankruptcy professionals—and certainly among trade creditors who get sued simply because the debtor paid a legitimate debt owed to them. Indeed, it was not always thus: under pre-1978 law, the trustee had to show that the transferee knew that the debtor was insolvent at the time of the transfer.

A final note: The overwhelming majority of preference cases are brought under federal law—Bankruptcy Code § 547. But some states also have preference laws, and the debtor can use those laws too. *See* § 544. As a debtor (and, again, when we talk about a "debtor's" avoidance powers throughout, we are using it as shorthand to mean the trustee or debtor-in-possession) considering a preference action, it is worthwhile having a look at state law; you might find something of use.

Watch for next month's issue—"The Trustee's Power to Avoid Fraudulent Transfers."