# A Short Primer on Defending Lawsuits to Recover Preferential Transfer

January 28, 2021

*Source: New Jersey Law Journal*

There are few things more unsettling to a client than receiving a demand letter or a complaint seeking to recover an alleged preferential payment. The average business person who is working to supply goods or services to customers already faces a lot of stress. The preference demand adds to that stress by demanding the return of payments for the goods and services actually provided. There is no allegation that the goods were defective or the services were inadequate. Rather, the Bankruptcy Code, and some states' insolvency laws, allow a trustee to make the demand. Debtors and others may also seek to recover preferential transfers in certain circumstances. Creditors facing such demands often complain that these laws are unfair. A response that they should call their representatives in Congress is unsatisfying, to say the least.

Yet, there is some good news. The Bankruptcy Code and state insolvency laws contain several defenses to the recovery of preferential transfers which often reduce or eliminate the preference exposure in many, if not most, cases. This article provides an overview of the defenses and suggestions to obtain the best settlement possible. Although this article focuses on monetary transfers, readers should be aware that other transfers, like the transfer of a security interest, may be preferential. Readers are invited to contact the author to discuss any of these matters in more detail.

Initially, a creditor should make the trustee prove all the elements of the claim. Among other requirements, the trustee must prove that an alleged preferential payment was a transfer of an interest of the debtor in property. The Supreme Court has interpreted the term "interest of the debtor in property" to mean "that property that would have been part of the estate had it not been transferred before the commencement of bankruptcy proceedings." Begier v. Internal Revenue Serv., 496 U.S. 53, 58, 59 n.3 (1990). Some payments made by debtors are not made from property that would otherwise be part of the bankruptcy estate. The earmarking doctrine, for example, provides that funds provided to a debtor for the purpose of paying a specific debt are not recoverable as a preference because the property "transferred" was never property of the debtor. Adams v. Anderson (In re Superior Stamp & Coin Co.), 223 F.3d 1004 (9th Cir. 2000).

The trustee must also prove, among other things, that the alleged preferential payment was on account of an antecedent debt, was made while the debtor was insolvent and was made on or within 90 days before the date of the filing of the petition. The antecedent requirement excepts pre-payment and COD arrangements from preference recovery. But note that a right to payment arises when goods are supplied or services are performed, not when an invoice is presented. Insolvency is measured by a balance sheet test when a debtor's liabilities exceed the fair value of its assets. The debtor is presumed to have been insolvent during the 90 days immediately preceding the filing of the petition, but this presumption may be overcome with evidence that the debtor was solvent when payment was received. For purposes of the requirement that payment be received within 90 days of the filing of the petition, a transfer by check occurs when the check is honored. Barnhill v. Johnson, 503 U.S. 393 (1992).

The Small Business Reorganization Act of 2019 added a new requirement that a preference claim be "based on reasonable due diligence in the circumstances of the case and taking into account a party's known or reasonably knowable affirmative defenses." Although it is unclear exactly what this new language requires, surely it requires a trustee to do more than simply send a demand letter to everyone who received a payment within 90 days of the bankruptcy filing. In light of this new requirement, the recipient of a preference demand should ask a trustee to detail the diligence he or she performed prior to sending a demand letter or filing suit.

There are two additional requirements to keep in mind. A trustee may not recover a preference if the recovery will not benefit the bankruptcy estate. There must be some benefit to creditors, even if it is indirect. A preference recovery is not permitted where it will benefit only the debtor. Additionally, a trustee may be required to bring a small preference action where the defendant resides. The venue provision at 28 U.S.C. § 1409(b) requires a trustee to bring an action to recover a consumer debt of less than $20,450, or a non-consumer debt of less than $25,000, in the district court where the defendant resides. This protects the far away defendant, residing in Texas or California, for example, from the need to retain local counsel to defend a small preference action pending in New Jersey or New York. Bankruptcy courts are split on this issue, with some courts holding that this venue provision does not apply to preference actions.

Even when the trustee is able to satisfy the elements of a preference claim, a creditor may still have defenses which reduce or eliminate its exposure. All potential defenses should be included in an answer as affirmative defenses. The two most frequently used defenses are ordinary course of business and subsequent new value.

The ordinary course of business defense is intended to protect recurring, customary credit transactions that are incurred and paid in the ordinary course of business. The 2005 amendments to the Bankruptcy Code made the ordinary course defense easier for creditors to establish. Post-2005, a "trustee may not avoid a transfer as a preference 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" either "(A) *made* in the ordinary course of business or financial affairs of the debtor and the transferee; or (B) *made* according to ordinary business terms." Davis v. All Points Packaging & Distrib. (In re Quebecor World (USA) Inc.), 491 B.R. 363, 368 (Bankr. S.D.N.Y. 2013) (emphasis added), adopted by, 2013 U.S. Dist. LEXIS 170359 (S.D.N.Y. Nov. 25, 2013).

The first part of the defense requiring that the underlying debt on which the payment was made be incurred by the debtor in the ordinary course of business is generally not controversial. If the debt was incurred in the routine operations of the debtor and the creditor, then it can be said to have been incurred in the ordinary course of each party's business. Even first-time debt can be debt incurred in the ordinary course of business of both parties.

The requirement in subpart (A) that the payments be made in the ordinary course is a subjective consideration of whether alleged preferential payments were consistent with the prior course of dealing between the parties. Courts consider the following types of factors when determining whether payments were made in the ordinary course of the parties' dealings: (1) the length of time the parties engaged in the type of dealing at issue; (2) whether the subject transfer was in an amount or form of tender different than previous payments; (3) whether there appears to be any unusual action by the debtor or creditor to collect on or pay the debt; and (4) whether the creditor did anything to gain an advantage in light of the debtor's deteriorating financial condition. Troisio v. E.B. Eddy Forest Products Ltd. (In re Global Tissue, LLC), 302 B.R. 808, 812 (D. Del. 2003), aff'd, 106 Fed. Appx. 99 (3d Cir. 2004). While these factors help ensure some consistency between payments prior to and during the preference period, absolute consistency in actual or average payment dates is unrealistic and not required. To help establish this element, the creditor should prepare a spreadsheet comparing payments received during the 90-day preference period to prior payments.

As an alternative to consideration of the prior dealings between the parties, subpart (B) allows the creditor to show that the allegedly preferential payments were made according to ordinary business terms. The relevant industry consists of firms that are similar in some general fashion to the creditor. Proving this element often requires expert testimony.

The subsequent new value defense provides that a transfer may not be avoided as a preference to the extent that, after such transfer, the creditor gave new value to the debtor on account of which the debtor did not make an otherwise unavoidable transfer to the creditor. This defense was enacted to encourage creditors to continue to provide goods and services on credit to companies experiencing financial difficulties. The Bankruptcy Code's definition of "new value" includes, "money or money's worth in goods, services, or new credit." New goods or services provided to a debtor during the 90-day preference period may be credited against all prior preferential transfers. New goods or services paid by a payment that is itself avoidable should still qualify as subsequent new value. As with the ordinary course of business defense, the creditor should prepare a spreadsheet showing the new value provided.

There are several other defenses that should be considered which are too numerous to mention in this article. Examples include a contemporaneous exchange of goods for payment from the debtor that is protected from recovery as a preference so long as both parties intended the exchange be substantially contemporaneous, even where payment is made several days after receipt of the goods. And, trustees may not avoid transfers with an aggregate value of less than $6,825 in cases of debtors whose debts are not primarily consumer debts. This list is not intended to be all inclusive.

Finally, Bankruptcy Code §502(h) allows creditors to file a claim for money returned to a trustee as a preferential transfer. Settlement discussions should include an offset for this claim if the trustee is able to estimate the recovery to creditors. If such estimation is not possible, then creditors should be careful not to inadvertently waive this claim in a settlement agreement. Although preference demands are never welcome, an awareness of the elements of the claim and all of the available defenses can mitigate the stress creditors experience when facing such claims.

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