troutman pepper

How Can You Protect and Defend Your Business From Preference Actions?

When a company files for bankruptcy, parties that did business with the troubled company are often left with outstanding amounts owed and a claim in the bankruptcy case for which they will likely get pennies on the dollar, if anything at all. Adding insult to injury, these same creditors are then often sued (referred to as a preference action) to claw back funds that the troubled company paid them in the months leading up to the bankruptcy on account of valid goods or services provided to the troubled company prior to the bankruptcy being filed. It comes as no surprise that almost nothing infuriates creditors of a bankrupt company more than preference actions.

What is a Preference Action?

Section 547 of the Bankruptcy Code allows a debtor to claw back funds paid to creditors within 90 days prior to the bankruptcy (and up to one year for insiders). The public policy behind a preference action is that all similarly situated creditors should be treated equally. In other words, certain creditors should not be paid (and thus preferred) while other creditors get nothing or pennies on the dollar for their claims. Instead, the idea behind Section 547 is that the money should be repaid to the bankruptcy estate and creditors should then share equally in the limited funds that are made available to all creditors. In general, a preference action must be commenced within two years of the date that the bankruptcy was filed.

Are There Any Defenses to a Preference Action?

In an effort to encourage creditors to continue to do business with a financially troubled company, the Bankruptcy Code provides several defenses to a preference action. Creditors often find it surprising that the undisputed validity of the goods sold or services rendered is not one of those defenses. The three most common defenses to a preference action are (i) the contemporaneous exchange for new value defense (the <u>CENV Defense</u>), (ii) subsequent new value defense (the <u>NV Defense</u>) and (iii) the ordinary course of business defense (the <u>OCB Defense</u>). At a high level, these defenses work as follows:

- The CENV Defense prevents recovery of a payment when the transfer was intended by the debtor and creditor to be a contemporaneous exchange (i.e., the goods/services were provided at the same time as the payment), and such exchange was in fact substantially contemporaneous.
- The NV Defense protects funds paid to a creditor where after receiving the payment, the creditor provided new goods or services to the debtor. The value of the new goods or services is offset

against the preferential payment received, thereby reducing the creditor's exposure. There are limits to this defense if the creditor later receives payment for the new goods and services.

- The OCB Defense shields a payment from avoidance if the payment was made according to ordinary payment terms between the debtor and the creditor (the subjective test) or was paid pursuant to ordinary industry terms (the objective test).
  - In considering the subjective test, courts will consider such factors as (1) the length of time the parties have engaged in business; (2) whether the transfer was in an amount more or less than usually paid; (3) whether the payments were tendered in a manner different from previous payments; (4) whether there were any unusual actions taken to collect or pay on the debt; and (5) whether the creditor did anything to gain an advantage in light of the debtor's deteriorating financial condition. A statistical analysis is often performed comparing the timing of payments in the historical period with the timing of payments in the preference period.
  - With respect to the objective test, the creditor must introduce evidence regarding the payment practice in the industry. For this reason, experts are often required to meet this defense.

What Steps Can I Take to Reduce the Risk That I will be Sued for a Preference?

There are steps a creditor can take to minimize its risk of preference exposure.

- I**nsist on Payment in Advance.** Section 547 of the Bankruptcy Code requires that the payment that is sought to be clawed back be on account of a pre-existing debt. In other words, the debtor must owe the creditor the money before the payment is made, i.e., the creditor has already provided the goods or services to the debtor and now wishes to be paid. If, however, the debtor pays for the goods or services before receiving the goods or services (payment in advance), then the payment cannot be a preference.
- **Maintain an Ordinary Course of Conduct Between the Parties.** A creditor should ensure that invoices are timely issued, and payment is made according to invoice terms. Procedures should be implemented to promptly and properly address delinquent payments as part of a creditors customary credit management practices, and all communications with the customer should be firm and require immediate payment of the outstanding invoice.
- **Implement COD Payment Term.** COD payments often fall within the CENV Defense. As such, by agreeing to COD payments and ensuring that payments are substantially contemporaneous with the delivery of the goods/services, a creditor will most likely have a defense to a preference action.

Takeaway

A creditor bears the burden of proving that one or more defenses applies to bar recovery. There are many nuances to preference defenses, both legal and factual. For this reason, it is essential that a creditor who has received a demand letter or a complaint seeking to claw back funds as an alleged preference, immediately contact experienced bankruptcy counsel.