

CREDITOR'S RIGHTS TOOLKIT

What Are Some Less Traditional Defenses to a Preference Action?

In a bankruptcy case, a preference action¹ is often asserted pursuant to Section 547 of the Bankruptcy Code against a creditor to claw back funds paid to the creditor in the 90 days prior to the bankruptcy. While the most common defenses to a preference action are the ordinary course of business defense², the new value defense³, and the contemporaneous exchange for new value defense⁴, there are other defenses that a savvy creditor should consider to reduce or even eliminate preference liability.

Key Issues

- **NO IMPROVEMENT IN POSITION DEFENSE**

The attachment of a commercial lender's floating lien on inventory and receivables is a "transfer" for purposes of Section 547. Section 547(c)(5) provides a safe harbor by providing that the debtor may only avoid as a preference the amount by which the floating lien creditor has reduced its unsecured position. The analysis focuses on whether the creditor has improved its position during the preference period, which is determined by measuring the extent of the creditor's debt in excess of the value of creditor's collateral at the beginning and end of the preference period.

- **INCHOATE LIEN DEFENSE**

A lien is a grant of a security interest in a piece of property under state law. An inchoate lien is a lien that has not yet been perfected. If a creditor could have perfected a lien against the debtor when it received a preferential payment, then the payment cannot be clawed back as a preference. To assert this defense, a creditor must show that it was entitled to perfect a lien under state law at the time it received the preferential payment but only failed to do so because the creditor received payment from the debtor. The theory behind this defense is that absent the preferential payment before the bankruptcy, the creditor would have perfected its lien and been entitled to receive the same payment in a liquidation, leaving the creditor in the same position with the same payment.

¹ See [How Can You Protect and Defend Your Business From Preference Actions?](#)

² See [Preference Actions: What is The Ordinary Course of Business Defense?](#)

³ See [What Is the New Value Defense to a Preference Actions?](#)

⁴ See [What Is the Contemporaneous Exchange Defense to a Preference Action?](#)

- **ASSUMED CONTRACT DEFENSE**

In certain jurisdictions, the assumption of an executory contract is a complete defense to a preference action. This defense reflects the idea that, if the preferential payment had not been made prior to the bankruptcy, the payment still would have been made during the bankruptcy when the debtor sought to assume the contract, leaving the creditor in the same position with the same payment. Unlike other defenses, this defense relies on events that occur after the bankruptcy case is filed and requires the creditor to be able to show that its executory contract was indeed assumed in the bankruptcy case.

- **MERE CONDUIT DEFENSE**

Section 550 of the Bankruptcy Code allows a debtor to seek to claw back funds from the initial transferee of such transfer or the entity for whose benefit such transfer was made. To be considered a mere conduit, a party must show that it received the funds not for its own benefit and that it lacked dominion and control over the funds. In other words, the party lacked the power to decide how to use the funds and that the funds simply passed through its hands.

- **DE MINIMIS PAYMENT DEFENSE**

For a debtor with primarily nonconsumer debts, a trustee may not be able to avoid a transfer or payment as a preference if the value of such transfer or payment is less than \$5,000.

Takeaway

The foregoing list of less traditional defenses is not comprehensive or exhaustive. Additional defenses may be available and of use to creditors. Nonetheless, each affirmative defense requires an in-depth analysis of the relevant facts and circumstance. A creditor should consult competent counsel to ensure it asserts the best affirmative defense(s) to limit its preference exposure.