

Don't Sweat the Small Stuff: Third Circuit Refuses to Aggregate Small Preference Claims to Meet the Minimum Threshold

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The Court of Appeals for the Third Circuit recently issued a decision on an issue of “first impression” that serves as a reminder to consider all defenses whenever a creditor is served with a preference demand. The Bankruptcy Code provides a statutory defense to preference claims when the transfer at issue is less than \$6,225. In *Slobodian v. IRS (In re Net Pay Solutions, Inc.)*¹, the court denied a trustee’s request to aggregate multiple transfers that were below the threshold on an individual basis, but which exceeded the threshold on a total basis. This means that a creditor may have a better chance of defending against a preference claim if it received multiple small payments instead of a larger lump sum payment (for example, receiving four payments of \$5,000 each instead one payment of \$20,000).

Preferences and the Minimum Threshold

A preferential transfer is a payment made by an insolvent debtor to a creditor on account of an antecedent debt made within 90 days before the filing of a bankruptcy petition. A trustee may avoid a preferential payment and recover the funds for the benefit of the debtor’s estate. This allows the recovered funds to be distributed equally among all of the debtor’s creditors. Exceptions (or defenses) to the trustee’s avoidance powers are also built into the preference statute. These include, among others, the contemporaneous exchange defense, the ordinary course of business defense, and the new value defense. Such defenses are often written about and commonly the subject of legal decisions. Creditors must be mindful, however, not to overlook a very simple defense: the minimum threshold defense found in Section 547(c)(9) of the Bankruptcy Code.

Section 547(c)(9) provides that a trustee may not avoid a preferential transfer “if, in a case filed by a debtor whose debts are not primarily consumer debts, the aggregate value of all property that constitutes or is affected by such transfer is less than \$6,225.” The minimum threshold defense is a relatively new provision which was added to the Bankruptcy Code in 2005 and designed to discourage litigation over relatively insignificant amounts. A scenario can easily be envisioned where a creditor might incur \$10,000 in legal fees to defeat a \$5,000 preference claim.

The Third Circuit’s Decision: *Slobodian v. IRS (In re Net Pay Solutions, Inc.)*

The debtor in the *Net Pay* case previously operated a business in which it managed its clients’ payrolls and handled their employment taxes. At issue in this case were five transfers that the debtor made on behalf of its clients to the Internal Revenue Service (“IRS”). The transfers included the following amounts, each on behalf of a different client of the debtor: (1) \$32,297; (2) \$5,338; (3) \$1,143; (4) \$352.84; and (5) \$281.13. Although four of the five payments were below the minimum threshold, the trustee argued that the transfers may be aggregated to exceed the minimum threshold.

The *Net Pay* case was unique because the trustee was suing a single defendant, the IRS, to recover payments made on behalf of multiple creditors. Therefore, the trustee was attempting to aggregate both the individual transfers and the different creditors in order to meet the minimum threshold. The Court rejected the trustee’s liberal aggregation approach. The Court noted that the trustee’s argument made little sense since a creditor’s ability to invoke the minimum threshold would depend on whether the debtor made transfers for the benefit of other creditors. Each of the debtor’s clients had no control over payments that were made to the IRS on behalf of the debtor’s other clients and the Court appropriately concluded that it would be unfair to aggregate the transfers.

The Court’s holding was specific to the trustee’s unique argument of attempting to aggregate multiple transfers below the minimum threshold that were for the benefit of different creditors and the Court’s dismissal of such argument is not surprising in light of the policy considerations. Although it was not a direct issue, the Court’s ruling also addressed the more common situation of a trustee aggregating multiple transfers to a single transferee to exceed the minimum threshold (for example, a creditor that received four separate transfers of \$5,000 each during the preference period is sued by the trustee for \$20,000). The Court stated that the text and context of Section 547(c)(9) demonstrates that the minimum threshold contemplates a transfer-by-transfer analysis. Thus, it is a reasonable interpretation that each of the separate transfers of \$5,000 in the example above should be viewed independently as each being below the minimum threshold and, therefore, none of the \$20,000 should be recoverable by the trustee.

1 Case No. 15-2833 (3d Cir. May 10, 2016).

The law is less clear, however, when considering the aggregation of multiple transfers to a single creditor. The Third Circuit cautioned that courts must not apply the minimum threshold in a mindless way that would permit a debtor and/or creditor to thwart the law by structuring multiple transfers in amounts less than the threshold. Indeed, courts have allowed a trustee to aggregate multiple transfers to satisfy the minimum threshold and the standards often applied are whether the transfers are on account of the same debt, or if the transfers are conducted pursuant to a single common plan.

Dealing with Small Transfers and the Minimum Threshold

As demonstrated by the Court's comments, creditors should be aware that payment by a debtor of multiple debts in a single transfer might expose the creditor to preference liability whereas there is at least a colorable defense that the minimum threshold would not have been satisfied if the transfers had been made separately. This situation could cause a dilemma for credit professionals. Any creditor dealing with a debtor that has fallen behind on a number of small debts would usually be happy to receive a lump sum payment to bring the account current. It is understandable that the creditor would not want to refuse a large payment in order to receive multiple smaller payments. This is one of those instances where, even at the risk of receiving a preferential transfer, it is always better to receive full payment rather than partial or no payment.

The benefit of the *Net Pay* decision is that it comes from the highest court in the circuit and provides creditors with additional ammunition for challenging preference claims that only meet the minimum threshold if the transfers are aggregated together. Do not assume that just because a preference action has been commenced that the trustee has done an analysis to determine whether the transfers meet the statutory minimum threshold. A trustee preparing multiple preference complaints is often working off of a spreadsheet analysis that simply shows the total amount of payments that the creditor received in the 90 days prior to the bankruptcy. A well-informed creditor will look at the individual amounts of the transfers to determine whether any are below the minimum threshold and may be easily challenged.

The same advice applies and is even more significant when receiving a demand letter for the return of an alleged preferential transfer. A trustee pursuing preference actions will often perform a cost benefit analysis and may decide that pursuing "small-dollar" preference claims is unlikely to result in a net benefit to the estate. At the demand letter

stage, however, which typically occurs prior to the trustee commencing formal lawsuits, the trustee generally has nothing to lose other than the cost of a stamp to see if a demand letter can cause a creditor to turn over funds to the trustee. Even if a demand letter is sent, the trustee may have no intention of actually commencing an action to recover the preferential transfers if they do not exceed a certain level. Make sure you keep the minimum threshold of \$6,225 in mind when receiving a preference demand letter.

Don't Forget About the Venue Limit

Although it was neither relevant to nor discussed in the *Net Pay* decision, the venue limit is another minimum threshold that creditors should be mindful of when dealing with preference demands. The venue provisions of the Bankruptcy Code require that a trustee commence a preference action in the district court for the district in which the defendant resides if the claim is less than \$12,475.² This requirement can make it especially burdensome for a trustee to recover small dollar preferences, since the trustee would much prefer to have a single forum (i.e., the bankruptcy court where the case is pending) to prosecute its actions. When a creditor residing outside the district of the bankruptcy court receives a demand letter for less than \$12,475, there is a strong likelihood that the trustee would not incur the expense of commencing a litigation to pursue the preference claim.

Conclusion

The minimum threshold defense may not get the same attention as the ordinary course of business or new value defenses, but it must not be forgotten since, in some cases, it is the easiest and most straightforward defense to apply. The Third Circuit's *Net Pay* decision illustrates that courts may be reluctant to adopt arguments that would undermine the intent of the statute of discouraging litigation over insignificant amounts.

2 28 U.S.C. § 1409

About the Author:

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