# Defending Preference Claims: What's Mine is Mine – What's Yours is Negotiable

**By William B. Creim and Laurie K. Jones**

## Introduction

This article discusses practical strategies for trade creditors who receive preference demand letters. It first reviews the basic preference law and defenses. Next, it discusses the different parties who may be responsible for collecting preferences, and finally, it outlines practical strategies for trade creditors to use when defending preference claims.

## The Preference Law and Defenses

***In many bankruptcies, a debtor's most significant asset is its preference claims against its creditors. The bankruptcy defines a preference as:***

- ***The transfer of an interest of the debtor in property,***
- ***to or for the benefit of a creditor,***
- ***for or on account of an antecedent debt owed by the debtor before such transfer was made,***
- ***made while the debtor was insolvent,[1] on or within 90 days before the filing of the bankruptcy petition (or within one year before the filing if the transferee creditor was an insider),***
- ***that enables the creditor to receive more than such creditor would have received if the case were a Chapter 7 liquidation proceeding.[2]***

The trustee has the burden of proof on each of the foregoing elements. Any preference action is also limited by a statute of limitations, which requires that the trustee commence a preference action the earlier of: two years after entry of the order for relief (in a voluntary bankruptcy, the date the petition was filed), or one year after the appointment or election of the first trustee if such appointment or election occurs before the expiration of two years after the order for relief, or the time the case is closed or dismissed.[3]

The Bankruptcy Code also provides several preference defenses which may be applicable to trade creditors. Briefly, the applicable preference defenses, and some examples of how they might be applied, are as follows:

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[1] Under Title 11, U.S.C. ("Bankruptcy Code"), the debtor is presumed to have been insolvent on and during the 90 days immediately preceding the date of filing the bankruptcy petition. See Bankruptcy Code § 547(f).

[2] Bankruptcy Code § 547.

[3] Bankruptcy Code § 546(a). CAVEAT: Some courts have applied the two-year statute of limitations for commencing a preference action in cases where a trustee has not been appointed.

## Contemporaneous Exchange For New Value

The contemporaneous exchange for new value defense applies where the transfer was intended by the debtor and creditor to be a contemporaneous exchange for new value given to the debtor by the creditor and was in fact a substantially contemporaneous exchange. New value is defined by the Bankruptcy Code to include money or monies worth in goods, services, new credit, or release of property previously transferred, but it does not include an obligation substituted for an existing obligation. Although there are no hard and fast rules as to how many days, weeks or even months will constitute a "contemporaneous exchange," the courts generally require that the transfer occur within 1 to 14 days of the transfer of new value to the debtor.[4]

If a trade creditor is doing business with a financially troubled debtor and wishes to preserve this defense, it is wise to create a new account ledger for the debtor and apply payments received to this account contemporaneously with any shipment being made to the debtor. Trade creditors often lose this defense where instead, they apply payments received by the debtor to aging invoices.

**Example:**

Within the 90 days preceding the debtor's filing of a bankruptcy petition, creditor sends debtor a shipment of goods, and one week later debtor transfers payment to creditor. Creditor applies the payment to the goods shipped one week previously, and debtor and creditor intended that this exchange be substantially contemporaneous. Most courts will find that this falls within the contemporaneous exchange defense.

## Ordinary Course of Business Defense[5]

Essentially, this defense applies where the debt was incurred in the ordinary course of the business of the debtor and creditor, paid according to the ordinary course of the business of the debtor and creditor and paid according to ordinary business terms (terms customary in the industry). The legislative history of this section states that it was designed to leave the normal financial/business relations of the debtor and his creditors undisturbed, but to "discourage unusual action" by the debtor and/or the debtor's creditors during the period when the debtor is sliding into bankruptcy.

Note that there are conflicting cases concerning which rule applies when debtor pays by check. The majority rule holds that the date of payment (transfer date) occurs on the date the check is honored by the bank; but there are some courts that hold that the transfer date is the date the check is received by the creditor.

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[4] As stated, this defense is dependent upon the intent of the parties. Therefore, courts have sometimes found an exchange of a much greater length to constitute a contemporaneous exchange.

[5] Bankruptcy Code § 547(c)(2).

**Example:**
Creditor's arrangement with debtor is that debtor pays on 60-day net terms, and this is a customary term in the industry. However, over the course of the prior two years, debtor frequently paid within 65 to 75 days. In the 90 days prior to filing bankruptcy, debtor
makes payments to creditor which are within 55 to 75 days net. Although the agreed upon terms were 60 days net, because debtor and creditor established a course of payment which was often 65 to 75 days net, if this occurred frequently enough, and if this was ordinary within the industry, most courts would probably find that none of the payments received within the 90 days prior to filing were a preference.

## Enabling Loan Exception (Security Interest For New Value)[6]
The enabling loan exception defense demonstrates one reason why it is often wise for trade creditors to consider taking a purchase money security interest in goods transferred to debtors. Under this defense, a transfer or a purchase money security interest in property acquired by the debtor cannot be avoided to the extent that the security interest secures new value that was given at or after the signing of the security agreement,[7] which agreement contains a description of the property as collateral, given by the secured party under the security agreement to enable the debtor to acquire the property. The security interest must be perfected on or before 20 days after the debtor receives possession of the property in order for this exception to apply. This defense applies when the trustee attacks the creation and perfection of a security interest, not the actual receipt of payment.

**Example:**
Within the 90 days prior to filing, the creditor perfects a purchase money security interest in property that creditor shipped to debtor, and creditor perfects the interest on the 18th day following shipment. The security agreement contains a description of the goods that the creditor shipped. Under this scenario, the trustee should not be able to avoid the purchase money security interest.

## Subsequent New Value Defense
This defense provides that the trustee may not avoid a transfer to or for the benefit of a creditor, if the creditor gave new value to the debtor (i.e., a subsequent shipment of goods) after the transfer, which was not secured by an otherwise unavoidable security interest and on account of which new value the debtor did not make an otherwise unavoidable transfer to or for the benefit of such creditor.

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[6] Bankruptcy Code § 547(c)(3).

[7] This exception will not apply if the creditor attempts to bootstrap the security interest to previously shipped goods.

**Example:**
Creditor receives a potentially preferential payment in the amount of $50,000. Creditor subsequently ships to debtor $60,000 worth of goods. Debtor then files bankruptcy. The result will be that the $50,000 payment was not a preference.

## No Improvement In Position By A Secured Creditor[8]

The trustee may not avoid a transfer of a perfected security interest in inventory or receivable or the proceeds of either, except to the extent that the aggregate of all such transfers (or perfected security interests) caused a reduction in the ratio between the indebtedness to that creditor and the value of that creditor's collateral as of the date of the petition and the 90th day preceding the filing of the petition, which prejudices other creditors holding unsecured claims. For non-insiders, this exception only applies to the transfer of a perfected security interest for the benefit of that creditor during the 90 days preceding the bankruptcy filing. As with the enabling loan exception, this exception does not apply to the receipt of payments by the creditor but instead protects the security interest.

## Know Your Enemy - Parties Responsible for Collecting Preferences

The strategies for defending against a preference claim are clearer if you understand who your opponent is and what his incentives are. Preference claims may be brought by any of several parties. These include the attorneys for:

- The debtor
- Court appointed trustee
- The creditors committee
- Collection firm

Regardless of the party bringing the claim, you should be aware of the following facts.

(1) In many cases the trustee, attorney or collection firm is employed on a contingency or other incentive based system. This generally encourages the claimant to try to settle claims quickly while spending as little time as possible.

(2) The debtor's records are generally a mess. As a result, initial preference demand letters are usually generated based merely on the debtor's check register, with no analysis of creditor-preference defenses.

(3) The claimant is usually pursuing numerous other preference claims. You aren't the only one. This leads to several issues which may effect your strategy:

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[8] Bankruptcy Code § 547(c)(5). As can be seen by the title of this defense, it often will not apply to the typical trade vendor creditor.

(A) Early settlements may set a precedent for future settlements. The claimant may, therefore, show less flexibility at the beginning than it will after most claims are resolved.

(B) Big claims get more attention than small claims. The amount of attention your case receives may have more to do with the comparative size of your claim than with its validity. The claimant may initially ignore or not be aware of any special facts concerning your claim. Additionally, you may be able to resolve a "small" nuisance size claim at a round number regardless of the strength of the preference claim or the weakness of your defenses.

## Practical Strategies For Defending Preference Claims

### *Delay*

You have the money. Hold on to as much of it for as long as you can. In some cases if you ignore the initial demand letter you may never hear from the claimant again.

### *Make The Claimant Disclose Its Legal Theory Before You Raise Your Defenses*

It is easier to defend a claim if you know the other side's factual and legal arguments. Therefore, a good strategy for an initial written creditor response is a letter to the claimant stating that your company records do not show any receipt of payments that would be considered a preference. The letter should ask the claimant to furnish you with any information they have supporting their preference claim against your company.

### *Analyze Your Defenses*

Once you receive available information concerning the preference claim you should analyze your defenses. If the claim is large, you may wish to retain the services of a bankruptcy attorney. A detailed letter to the claimant setting forth defenses to all claimed amounts is usually the next step. You may wish to include a very low settlement offer in this letter.

### *Cost-Benefit Settlement Analysis*

Settlement strategies depend on the size of the claim and the strength of your defenses. Even if you are "dead-in-the-water" without any viable defense, you still have negotiating power. You have the money. They don't. Don't ever offer 100 cents on the dollar. In almost all cases, the claimant will take less than the obvious preference amount just to settle the case. How much less depends on the facts of the case and the size of the claim.

Keep in mind any additional influence you have with the debtor. If your debtor is attempting a chapter 11 reorganization, you may be able to use your other negotiating points (e.g. your willingness or unwillingness to sell on shortened credit terms to the post-petition debtor) to help reach a satisfactory settlement of the preference claim. Additionally, you may be able to link resolution of any reclamation claim you have to resolution of the debtor's preference claim against your company. Finally, you may be able to extend negotiations to include the amount of your company's claim in the bankruptcy and the classification of that claim in the debtor's plan.

If you reach a settlement, be careful what you sign. Do not sign a full written release if you have additional claims against the debtor. At the very least, any amount you pay as a preference should be added to your bankruptcy claim against the debtor.

Do not make your best offer at the beginning. Unless the claim is small and you just don't want to be bothered, start with a low offer and increase it only when necessary.

## Conclusion

An amazing event occurs when mass mailings of preference demand letters are sent to trade creditors. Some creditors pay, in full, by return mail. Never, ever, ever, respond to a preference demand letter by sending a check. Instead, try using the practical strategies set forth in this article.

A creditor who utilizes the preference defense strategies discussed in this article should be able to reduce the amount it has to pay in response to preference demands. A basic knowledge of the preference law, preference defenses, and the preference demand and recovery procedures provide the foundation for using these preference defense strategies.

***William B. Creim is the managing partner of the Los Angeles office of Bronson, Bronson & McKinnon LLP. He practices in the areas of commercial law, UCC law, secured transactions, creditor-debtor workouts, negotiations, bankruptcy and antitrust. Laurie K. Jones is a lawyer in the Bankruptcy and Creditors' Rights Practice Group of Bronson, Bronson & McKinnon LLP. She practices in the areas of bankruptcy, commercial litigation, and entertainment and defamation litigation. Prior to joining the firm, Ms. Jones worked at the United States Department of Justice, Office of the United States Trustee in San Bernardino, CA.***

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