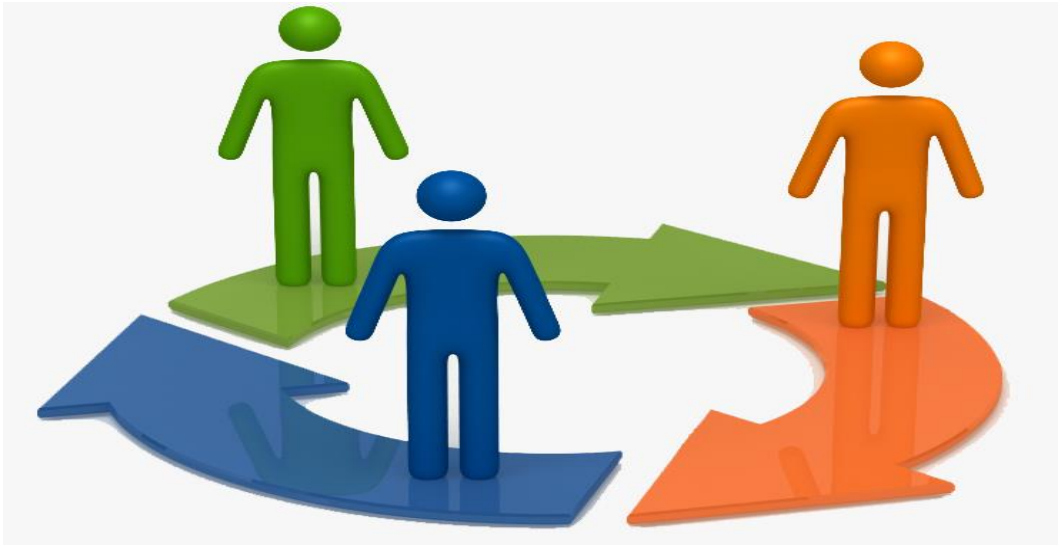

Bankruptcy – Focus on Preference Law Changes & Developments

Webinar Presentation For Credit Research Foundation

March 12, 2021

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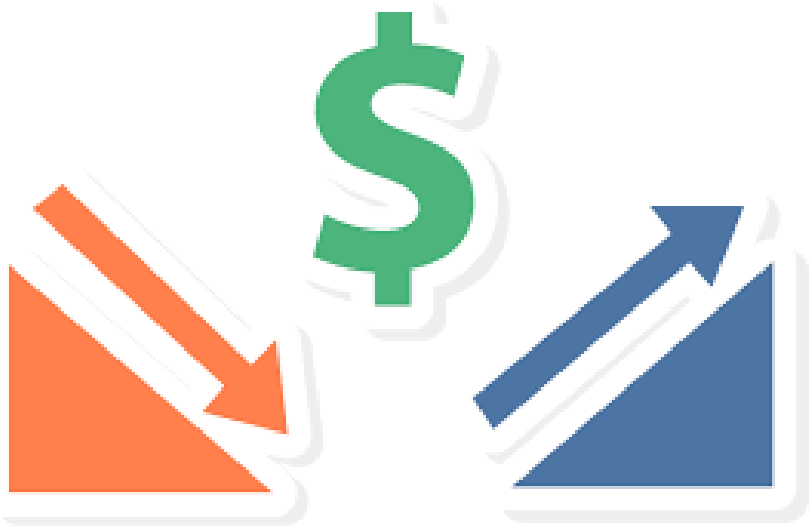
PREFERENCES: ELEMENTS AND ORDINARY COURSE OF BUSINESS AND NEW VALUE DEFENSES



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PREFERENCES UNDER SECTION 547 OF THE BANKRUPTCY CODE

ELEMENTS OF A PREFERENCE

- Section 547 of the Bankruptcy Code allows a debtor-in-possession or trustee to recover certain payments made prior to the debtor's bankruptcy filing, if the following elements are proven:
  - (1) Any Transfer of an Interest of the Debtor in Property;
  - (2) To or for the Benefit of a Creditor;
  - (3) On Account of an Antecedent Debt Owed by the Debtor Before the Transfer:
    - Cash in advance payments not preferences

PREFERENCES UNDER SECTION 547 OF THE BANKRUPTCY CODE

ELEMENTS OF A PREFERENCE

(4) Made While the Debtor was Insolvent;

- On or within 90 days before a bankruptcy filing; or
- Between 90 days and one year before a bankruptcy filing for transfers made to insider creditors; and

(5) That Enables Such Creditor to Receive More Than Such Creditor Would Receive if:

- The case were a Chapter 7 case;
- The transfer had not been made; and
- Such creditor received payment to the extent provided by other provisions of the Bankruptcy Code.

Frequently Asserted Preference Defenses

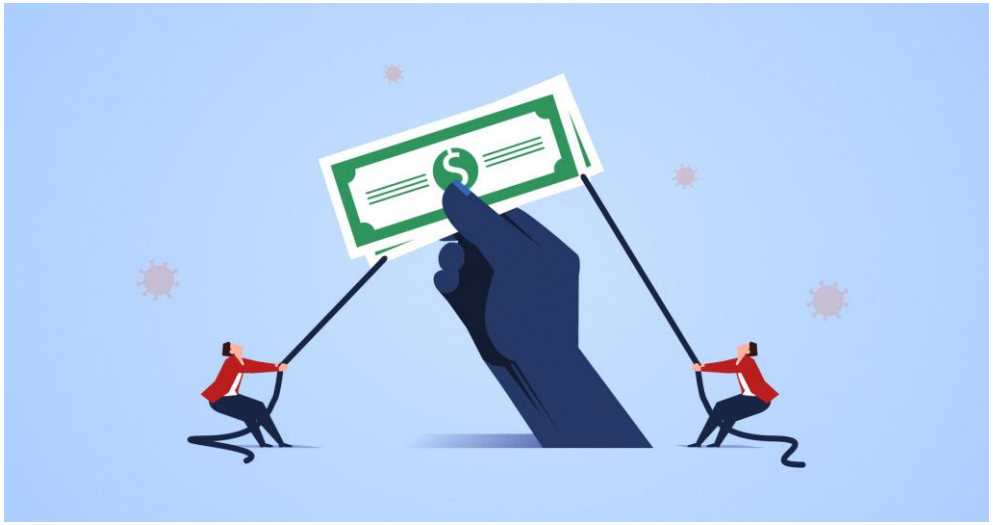
Ordinary Course of Business Defense

- 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 Creditor; and
- Subjective Test – Made in the Ordinary Course of Business or Financial Affairs of the Debtor and the Creditor; OR
- Objective Test – Made According to Ordinary Business Terms

Subsequent New Value Defense

- Creditor Extended Credit to Debtor After Payment, That was not Secured, and not Paid, by an Otherwise Unavoidable Transfer
- New Value Cannot be Applied to Subsequent Payments

RECENT BANKRUPTCY CODE AMENDMENTS AFFECTING PREFERENCE CLAIMS



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2019 Bankruptcy Code Amendment: SBRA

- Designed to Expedite, Reduce Costs, and Increase Exit Prospects
- Became Effective February 19, 2020
- Permitted any Business With Maximum Aggregate Debt of $2,725,625 to File Bankruptcy as a Small Business Chapter 11 Debtor
- The Coronavirus Aid, Relief and Economic Security Act ("CARES" Act) was Enacted on March 27, 2020 and Sunsets/Expires on March 27, 2021
  - The maximum aggregate debt limit to qualify as a small business (excluding affiliates and insiders) provided for under the SBRA was increased to $7,500,000, not less than 50 percent of which is required to arise from the commercial or business activities of the debtor

SBRA's Changes To Preference Law With The Goal of Avoiding Abusive Practices

- Bankruptcy Code §547(b) was Amended to add the Following Purported Due Diligence Requirement to be Undertaken Before Filing Preference Litigation:
  - "(b) Except as provided in subsections (c) and (i) of this section, the trustee may, *based on reasonable due diligence in the circumstances of the case taking into account a party's known or reasonably knowable affirmative defenses under subsection* (c), avoid any transfer of an interest of the debtor in property…."
  - Preference defendants still have the burden of proving preference defenses
  - It is unclear what is actually required to allege lack of diligence

Increased Venue Limits On Small Claims

- The Venue Provision That Forces a Trustee or Debtor-in-Possession to Commence Litigation on Smaller Claims in the District Court Where the Defendant Resides (Corporate Headquarters or Principle Place of Business) has Been Increased From $13,650 to $25,000
  - Impact: Trustees/debtors-in-possession may be less likely to commence suit on preference and other claims seeking recovery of less than $25,000
- Does the Increased Venue Limit Apply to Bankruptcy Cases Filed Before SBRA's Effective Date of February 19, 2020?
- Legislation Ignores Prior Conflicting Decisions Over Applicability of Venue Limit to Preference/Other Avoidance Actions

Consolidated Appropriations Act of 2021

- The “CAA” was passed on December 21, 2020 and was enacted on December 27, 2020
- The CAA is a $2.3 trillion spending bill comprised of $900 billion in COVID-related relief and a $1.4 trillion omnibus spending bill for fiscal year 2021
- Impact on preference claims: The CAA amended Section 547 of the Bankruptcy Code to create a new preference exception: “covered payment[s] of supplier arrearages”
- The amendment is intended to address risk of loss of ordinary course of business defense where creditor had extended the due date of payment of invoices due to the pandemic

"Covered Payment" Exception to Preference Liability
Temporary Subsection 547(j)

- Creates a New Preference Exception: "covered payment of supplier arrearages"
  - Payment made in connection with an *agreement* or *arrangement* made or entered into on and after March 13, 2020 (onset of COVID) between a debtor and a supplier of goods or services to delay or postpone payment of amounts due under an *executory contract*
  - Payment cannot exceed the amount due under the executory contract before March 13, 2020
  - Does not include fees, penalties and interest in an amount greater than that scheduled to be paid under the contract or which the debtor would owe if the debtor had made all payments on time and in full before March 13, 2020
- Exception for landlords, too: "Covered Payment of Rental Arrearages"
- Sunsets on December 27, 2022, but continues to apply to bankruptcy cases filed before December 27, 2022

"Covered Payment" Exception to Preference Liability

Raises More Questions Than Answers?

- Who has the burden of proof?
  - Trustee or creditor?
  - Section 547(b) vs. Section 547(c)?
- Only Deals With Payments under an Executory Contract
  - *The "Countryman" definition* - An executory contract is one under which both parties to the contract have unperformed obligations such that the failure of either party to continue or complete performance would constitute a material breach that excuses the other party from performance.

"Covered Payment" Exception to Preference Liability

Raises More Questions Than Answers?

- What is an *Arrangement* to Defer or Postpone Payments?
  - How does it differ from an *agreement*?
  - Is a creditor's unilateral decision to defer payment sufficient?
  - Must the creditor announce the deferral? Does it need to be in writing?
  - Best practice: document and execute forbearance agreement
- Can the Creditor Defer Payments While Requiring Payment of Late Charges, Interest, or Attorneys' Fees?
  - Best practice: avoid charging fees, interest, and charges
- Meaning of Requirement That a "Covered Payment" not Exceed the Amount due Under the Executory Contract Before March 13, 2020?

RECENT ISSUES IMPACTING PREFERENCE DEFENSES

Section 503(b)(9) “20 Day” Administrative Priority Claims

- Administrative Claim for the Value of the Goods the Debtor Received Within 20 Days of Bankruptcy Filing
- 20 Day Goods Must be Sold to the Debtor in the Ordinary Course of the Debtor’s Business
- Safety Net for Trade Creditors that Supply Goods Not Services!
- Replaces Reclamation as an Effective Value Maximizing Trade Creditor Remedy

Is Paid § 503(b)(9) Claim Eligible As New Value?

- Yes: *In re Commissary Operations, Inc.*, U.S. Bankruptcy Court, Middle District of Tennessee
  - New value window closes on bankruptcy filing date (same analysis applied by 3rd Circuit court in *In re Friedman's*)
  - The new value defense is not impacted by post-petition payments of new value
  - Section 503(b)(9) claims are improperly impaired if excluded from the new value defense

Paid § 503(b)(9) Claim Is Not Eligible As New Value

- No: *In re Circuit City Stores* (U.S. Bankruptcy Court, Eastern District of Virginia) and *In re TI Acquisition LLC* (U.S. Bankruptcy Court, Northern District of Georgia)
- Paid § 503(b)(9) Priority Claim Does Not Satisfy Bankruptcy Code § 547(c)(4)'s Requirement That "the Debtor did not Make an Otherwise Unavoidable Transfer to or for the Benefit of Such Creditor" as a Post-Petition Payment was Received by the Creditor
- A Creditor is Double Dipping if it can use its Fully Paid/Funded § 503(b)(9) Claim as Part of its new Value Defense

Critical Vendor Payment Impact on New Value Preference Defense

- Debtors often obtain authority to pay prepetition claims of "critical vendors" on the premise that if the vendor refused to provide goods or services on credit post-petition, the debtors' business would be irreparably disrupted and, as a result, the Debtors' efforts to maximize value for their estates and creditors would be severely impaired.
- Does Critical Vendor Lose § 547(c)(4) new Value Defense As a Result of Debtor's Post-Petition Payment of Claim?
  - NO: U.S. Court of Appeals 3rd Circuit in *In re Friedman's which* counted new value paid post-petition pursuant to court order
    - New value is determined as of the bankruptcy filing date when claim was unpaid

Critical Vendor Payment Impact on New Value Preference Defense

- Other U.S. Circuit Courts of Appeal have not yet ruled on this issue
- Certain lower courts have disqualified new value paid post-petition
- **Suggestion:** Critical vendor order should either release preference claims against the vendor, or preserve the new value defense.
  - This protection might be hard to obtain unless the creditor has a lot of leverage, but is important now based on positions that debtors and post-confirmation entities have recently been taking.

Preference Claim as Basis for Objection to 503(b) Administrative Priority Claim

- Courts are Divided Over Whether a Trustee can Invoke Section 502(d) of the Bankruptcy Code to Assert a Preference Claim to Disallow an Administrative Priority Claim
  - Section 502(d) provides that "the court shall disallow any claim of any entity from which property is recoverable under [chapter 5 of the Bankruptcy Code . . . Unless such entity or transferee has paid the amount, or turned over any such property, for which such entity or transferee is liable under [chapter 5 of the Bankruptcy Code]."

Preference Claim as Basis for Objection to 503(b) Administrative Priority Claim

- Majority View – preference claim not grounds for disallowance of administrative claim
  - *In re Ames Merchandising Corp.*, (2d. Cir. 2009)
  - *In re CM Holdings, Inc., (Bankr. D. Del. 2000)*
  - *In re Lids Corp.* (Bankr. D. Del. 2001)
- Minority View – preference claim *is* grounds for disallowance of administrative claim
  - *In re Microage, Inc*. (9th Cir. B.A.P. 2002)
- This issue may be litigated in connection with the *Southern Food Group, LLC (d/b/a Dean Foods)* chapter 11 cases pending in the Southern District of Texas bankruptcy court.

Preference Claim As Basis For Disallowance Of § 503(b)(9) Administrative Priority Claim (§ 502(d) Of the Bankruptcy Code)

- Courts are Divided Over Whether a Preference Claim (Complaint Filed or Otherwise Asserted) can be Invoked to Temporarily Disallow a § 503(b)(9) Priority Claim
- One View: Preference Claim not Grounds for Disallowance of § 503(b)(9) Priority Claim
  - *In re Energy Conversion Devices, Inc. and Plastech Engineered Products, Inc.* – U.S. Bankruptcy Court, Eastern District of Michigan
  - *In re TI Acquisition LLC* – U.S. Bankruptcy Court, Northern District of Georgia
  - *In re Momenta, Inc.* – U.S. Bankruptcy Court, New Hampshire
  - *In re Plastech Enigneered Prods., Inc*. (E.D. Mich. 2008)
- Contrary View: Debtor could assert preference claim as basis for temporarily disallowing § 503(b)(9) priority claim
  - *In re Circuit City* – U.S. Bankruptcy Court, Eastern District, Virginia

Critical Vendor Defense

- Critical vendors subject to preference risk have asserted the "critical vendor defense"
  - *i.e.*, the plaintiff cannot prove section 547(b)(5) (one of the elements of a preference claim) that the alleged preferential transfer enabled the creditor to receive more than the creditor would have received in a hypothetical chapter 7 liquidation.
- This "critical vendor defense" has achieved mixed results:
  - *AFA Inv. Inc. v. Trade Source, Inc*., (Bankr. D. Del. 2015) - Delaware bankruptcy court upheld critical vendor defense where the debtor executed a letter agreement requiring the debtor to pay prepetition claim.
  - *HLI Creditor Trust* (D. Del. 2004); *Zenith Idus. Corp.* (D. Del. 2005); and *Personal Communications Devices, LLC* (Bankr. E.D.N.Y. 2018).
- Recent decision of Delaware bankruptcy court, in *Maxus Energy Corp.* (Bankr. D. Del. 2020), rejected critical vendor defense, relying largely on *HLI* and *Zenith*.

QUESTIONS?

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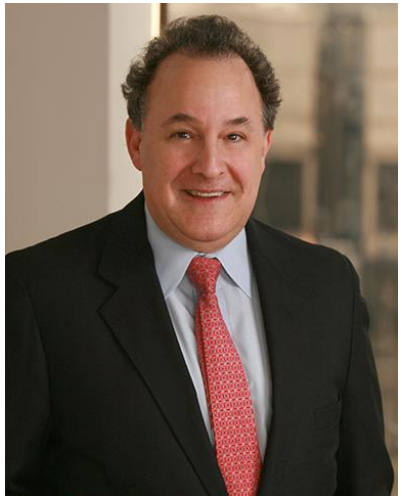

With more than 35 years of experience in the bankruptcy and insolvency field, Bruce is a recognized leader nationwide in trade creditor rights and the representation of trade creditors in bankruptcy and other legal matters. He has represented trade and other unsecured creditors, unsecured creditors' committees, secured creditors, and other interested parties in many of the larger Chapter 11 cases that have been filed. Bruce also handles letters of credit, guarantees, security, consignment, bailment, tolling, and other agreements and legal credit issues for the credit departments of institutional clients.

Among his various legal recognitions, Bruce received the Top Hat Award in 2011, a prestigious annual award honoring extraordinary executives and professionals in the credit industry. He was co-chair of the Avoiding Powers Committee that worked with the American Bankruptcy Institute's (ABI) Commission to Study the Reform of Chapter 11, participated in ABI's Great Debates at their 2010 Annual Spring Meeting–arguing against repeal of the special BAPCPA protections for goods providers and commercial lessors–and was a panelist for a session sponsored by ABI. He is a frequent presenter at industry conferences throughout the country, as well as a prolific author regarding bankruptcy and creditors' rights topics in various legal and trade publications.

Bruce is a co-author of "Trade Creditor's Risk-Mitigation Tools and Remedies Manual," published by ABI in 2019. He has also contributed to *ABI Journal* and is a former member of ABI's Board of Directors and former co-chair of ABI's Unsecured Trade Creditors Committee.

Education

- University of Pennsylvania Law School (J.D. 1980)
- Wharton School of Finance and Business (M.B.A. 1980)
- University of Rochester (B.A. 1976), Phi Beta Kappa

Bar Admissions

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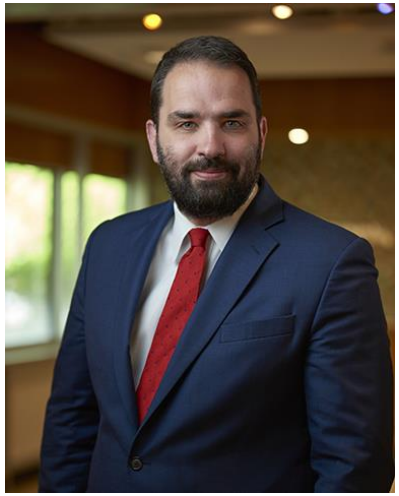

Andrew Behlmann is a partner in Lowenstein Sandler's Bankruptcy & Restructuring Department. Andrew leverages his background in corporate finance and management to approach restructuring problems, both in and out of court, from a practical, results-oriented perspective. With a focus on building consensus among multiple parties that have competing priorities, Andrew is equally at home both in and out of the courtroom, and he has a track record of turning financial distress into positive business outcomes. Clients value his counsel in complex Chapter 11 cases, where he represents debtors, creditors' committees, purchasers, and investors.

Andrew writes and speaks frequently about bankruptcy matters and financial issues. Before becoming a lawyer, he worked in senior financial management at a midsize, privately held company.

Education

- Seton Hall University School of Law (J.D. 2009), magna cum laude; Order of the Coif
- University of Missouri-Saint Louis (B.S. 2005), Business Administration-Finance and Accounting; *Beta Gamma Sigma*

Bar Admissions

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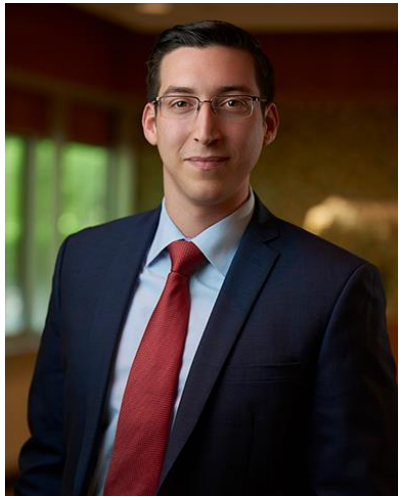

Michael provides counsel to debtors, creditors' committees, individual creditors, liquidating trustees, and other interested parties with respect to corporate bankruptcy and creditors' rights matters, including bankruptcy-related litigation.

Reliable and efficient, Michael is appreciated for his innate ability to effectively apply and communicate his understanding of the law and general business principles with respect to complex issues, both while providing advice to clients and while aggressively advocating on their behalf. Michael works tirelessly to understand clients' needs and provide practical solutions that are reasonable, balanced, and favorable to the clients he serves.

Michael takes pride in his commitment to the community and provides pro bono representation to individuals and a nonprofit organization regarding bankruptcy and foreclosure-related matters.

Prior to joining the firm, Michael held multiple clerkships in the U.S. Bankruptcy Court; he clerked for the Hon. Jerrold N. Poslusny, Jr. (District of New Jersey), the Hon. Ashely M. Chan (Eastern District of Pennsylvania), and the Hon. Gloria M. Burns (Chief Judge, District of New Jersey). Michael applies the valuable insights learned from working closely and directly with these members of the judiciary to his everyday practice.

Education

- Rutgers Law School (J.D. 2014), *Rutgers Journal of Law & Public Policy*
- The College of New Jersey (B.S. 2010), Criminology

Bar Admissions

- New York
- New Jersey

Recent Publications

- February 2021
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  Bruce S. Nathan, Scott Cargill

- January 2021
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  Critical-Vendor Status: An Additional Preference Defense?, *ABI Journal*
  Bruce S. Nathan, Scott Cargill, John P. Schneider

- September/October 2020
  Critical Vendor Treatment May Not Absolve Trade Creditors from Preference Risk, *Business Credit*
  Bruce S. Nathan, Michael Papandrea

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