DEFENDING PREFERENCES AFTER THE BANKRUPTCY REFORM ACT OF 2005

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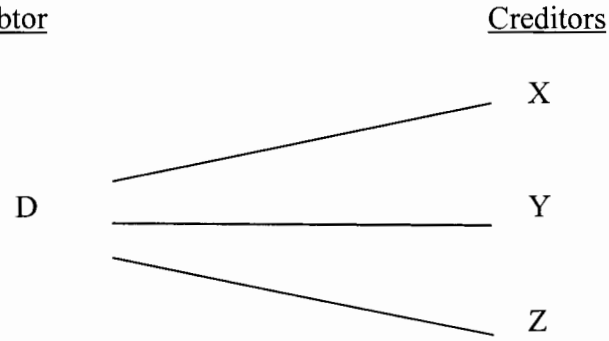
I. INTRODUCTION TO THE CONCEPT OF A PREFERENCE

Common law does *not* condemn a preference. Under common law, a debtor--even an insolvent debtor--may treat certain creditors more favorably than other similar creditors. Although D owes X, Y, and Z $1,000 each, D may pay X's claim in full before paying any part of Y's claim or Z's claim.



Preference: D pays X $1,000,
pays Y and Z nothing

Bankruptcy law *does* condemn *certain* preferences. A Congressional report that accompanied a draft of the original 1978 Bankruptcy Code explained the rationale for such a bankruptcy policy as follows:

> "The purpose of the preference section is two-fold. First, by permitting the trustee to avoid pre-bankruptcy transfers that occur within a short period before bankruptcy, creditors are discouraged from racing to the courthouse to dismember the debtor during his slide into bankruptcy. The protection thus afforded the debtor often enables him to work his way out of a difficult financial situation through cooperation with all of his creditors. Second, and more important, the preference provisions facilitate the prime bankruptcy policy of equality of distribution among creditors of the debtor. Any creditor that received a greater payment than others of his class is

required to disgorge so that all may share equally." House Report 95-595 at 117-78.

Bankruptcy Code Section 547(b) sets out the elements of a voidable preference. The bankruptcy trustee may void any transfer of *property of the debtor* if he can establish:

(1) the transfer was "to or for the benefit of a creditor"; and

(2) the transfer was made for or on account of an "antecedent debt," *i.e.*, a debt owed prior to the time of the transfer; and

(3) the debtor was insolvent at the time of the transfer; and

(4) the transfer was made within 90 days before the date of the filing of the bankruptcy petition, *or*, was made between 90 days and 1 year before the date of the filing of the petition to an "insider"; and

(5) the transfer has the effect of increasing the amount that the transferee would receive in a Chapter 7 liquidation case.

II. THE BANKRUPTCY REFORM ACT OF 2005

(Bankruptcy Abuse Prevention and Consumer Protection Act of 2005)

Prior to the latest reform measures, the last major overhaul of the United States Bankruptcy Code (Title 11 of the United States Code) occurred in 1994. At that time, a blue-ribbon panel (the National Bankruptcy Review Commission) was assembled to review the entire federal bankruptcy system and make recommendations for further legislative reforms. Following four years of deliberation and the opportunity for public input and comment from various interested constituencies, the Commission issued its recommendations in 1998, proposing some 172 different statutory enhancements.

Every Congress following the 1998 recommendations (eight congressional session years!) entertained proposed bankruptcy reform legislation in both the House and Senate. Substantial reforms succeeded in one house or the other, and some concepts were even approved in

both houses, but in spite of herculean efforts to achieve compromises and reach a consensus on a single piece of legislation, no single reform bill was passed and signed into law until April 20, 2005. Bankruptcy reform has clearly been a political football, and emotional "sideshow" issues such as abortion and farm aid repeatedly took the forefront while the real issues of bankruptcy law and case administration went begging.

The 2005 Act makes substantial changes to a comprehensive array of bankruptcy concepts, most of which changes go into effect on October 17, 2005. The changes in the preference arena are significant for the business credit community in three important ways: (1) the most "popular" defense to a preference - the ordinary course of business defense—has been made easier to prove; (2) small preferences in business cases - involving less than $5,000.00 - can no longer be pursued by the Trustee *at all*; and (3) small preferences in business cases - involving less than $10,000.00 - must be brought in a venue convenient to the affected creditor, rather than in a distant forum intended to make defending the case uneconomic. Also, the forward contract defense, applicable in certain industries selling goods (such as natural gas) on a forward basis, has been made broader in scope.

III. PRE-BANKRUPTCY DANGER SIGNALS

A. CHECKLIST OF EARLY WARNING SIGNS

1. Incomplete or Outdated Financial Information
2. Slowing Payment Trend
3. Partial Payment of Invoices
4. Staff Turnover

5. Continued Failure to Accept or Return Creditor Calls For Payment Information

6. Missed Tax Payments

7. Recent Expansion of Business

8. Increase in Accounts Payable

9. Undercapitalization/Excessive Leverage

None of the warning signs listed above can accurately predict the filing of a bankruptcy, but they can give you reason to monitor an account more carefully and restrict credit unless you receive assurances of the debtor's ability to handle its financial obligations.

B. RESTRUCTURING THE DEBT—"THE WORKOUT"—AVOIDING PREFERENCES

Collection claims are very often settled at some step in the recovery process by a mutual accommodation between the debtor and creditor. The parties stipulate to a balance owed (which can either be the original account or some compromise figure), the creditor agrees to the renewal and extension of such debt, and the debtor commits to make payments on a schedule pursuant to the terms of the extension. The terms may include an initial or downpayment on the stipulated balance (which may or may not be augmented by reimbursement of the creditor's Court costs, attorneys' fees, accrued interest, and other expenses of collection) followed by a period of installment payments (which may or may not include interest during the period of extension, and may or may not all be at the same monetary level). The creditor's decision to enter into such an arrangement is based upon factors such as the debtor's net worth, available non-exempt assets, cashflows, and reasons associated with resolving the merits of any dispute in the case. The debtor's decision is based upon some willingness to recognize the validity of the debt (to a greater or lesser

extent) and the value of extending the obligation while enjoying a moratorium on the creditor's formal efforts to collect. Documentation can be as simple as a promissory note, if the accord is reached prior to suit being filed. If a lawsuit is pending, such arrangements are often secured by allowing the creditor to hold an agreed or "confessed" judgment, without initiating any formal post-judgment collection procedures except in the event of default. If a judgment has already been taken, the extension is often covered in a written agreement calling for a moratorium of efforts to collect such judgment, which expires in the event of the debtor's default.

The type of arrangement described above is often referred to as a restructuring or "workout," particularly if the debtor simultaneously enters into similar arrangements with multiple creditors (or all of his creditors). One of the largest risks for a creditor entering into a "workout" agreement with the debtor is the risk that some or all of the payments made under the "workout" will be deemed preferential in the event of the debtor's bankruptcy.

A sad scenario occurs when the creditor makes concessions and compromises at the time of entering into the "workout," following which the debtor files for bankruptcy protection. Very often, the creditor is compelled to return payments as preferential, but the debtor attempts to retain the benefits of the concessions or compromises. One way to minimize this risk is to structure the agreement so that the debtor does not earn any waiver, compromise, release, or concession until 90 days elapses behind the last workout payment with no bankruptcy petition having been filed. At least if the debtor goes into bankruptcy, the creditor can present a case for lodging its full uncompromised claim.

WRONG

1. COMPROMISE
2. PAYMENTS

   LESS THAN 90 DAYS

3. BANKRUPTCY

RIGHT

1. PAYMENT AGREEMENT
2. PAYMENTS

   MORE THAN 90 DAYS

3. COMPROMISE OR RELEASE

IV. WHAT DOES A PREFERENCE CASE LOOK LIKE?

A preference case is a lawsuit (known as an "Adversary Proceeding") brought in relation to a pending bankruptcy. The Plaintiff is the Trustee (which may be the debtor in Chapter 11 cases with the debtor-in-possession). The Defendant is the transferee of the preferential transfer (*i.e.* the creditor who was paid on a debt justly owed). The Court's jurisdiction and venue must be properly invoked, and service of process must be perfected as in any lawsuit. The Complaint which initiates the Adversary Proceeding must give fair notice of the elements of the Trustee's case. Rules of Procedure and Rules of Evidence apply in the preference Adversary Proceeding, as in any federal court lawsuit. See Exhibit "A" hereto.

V. TRUSTEE'S CASE

1. Insolvency

Bankruptcy Code § 547(f)

(f) For the purposes of this section, the debtor is presumed to have been insolvent on and during the 90 days immediately preceding the date of the filing of the petition.

While the bankruptcy Trustee has the benefit of this presumption of insolvency, it is a presumption which may be overcome with sufficient evidence in particular cases.

INSOLVENT?

BANKRUPTCY

90 DAYS

2. Insider or Outsider

Bankruptcy Code § 101(31)

(31) The term "insider" includes--

(A) if the debtor is an individual--

(i) relative of the debtor or of a general partner of the debtor:

(ii) partnership in which the debtor is a general partner;

(iii) general partner of the debtor; or

(iv) corporation of which the debtor is a director, officer, or person in control;

(B) if the debtor is a corporation--

(i) director of the debtor;

(ii) officer of the debtor;

(iii) person in control of the debtor;

(iv) partnership in which the debtor is a general partner;

(v) general partner of the debtor; or

(vi) relative of a general partner, director, officer, or person in control of the debtor;

(C) if the debtor is a partnership--

(i) general partner in the debtor;

(ii) relative of a general partner in, general partner of, or person in control of the debtor;

(iii) partnership in which the debtor is a general partner;

(iv) general partner of the debtor; or

(v) person in control of the debtor;

(D) if the debtor is a municipality, elected official of the debtor or relative of an elected official of the debtor;

(E) affiliate, or insider of an affiliate as if such affiliate were the debtor; and

(F) managing agent of the debtor.

Note that in insider preference cases although the reach-back period is one year, the presumption of insolvency in favor of the trustee only applies to the last ninety days before filing.

THE DEPRIZIO RULE IS *VERY* DEAD: TAKE AS MANY GUARANTIES AS YOU CAN GET!

Bankruptcy Code § 547(i)

> (i) If the trustee avoids under subsection (b) a transfer made between 90 days and 1 year before the date of the filing of the petition, by the debtor to an entity that is not an insider for the benefit of a creditor that is an insider, such transfer shall be considered to be avoided under this section only with respect to the creditor that is an insider.

3. Hypothetical Liquidation

The hypothetical liquidation element, which essentially tests whether the transfer improved the creditor's position, will be satisfied unless the creditor was fully secured before the transfer or the property of the estate is sufficiently large to permit 100% payment to all unsecured claims. Assume, for example, that D makes a $1,000 payment to C, a creditor with a $10,000 unsecured claim, on January 10. On February 20, D files a bankruptcy petition. The property of the estate is sufficient to pay each unsecured creditor 50% of its claim. An unsecured creditor with a $10,000 claim will thus receive $5,000. C, however, will receive a total of $5,500 from D and D's bankruptcy unless the January 10th transfer is avoided. ($1,000 + 50% X (10,000 - 1,000)). Accordingly, the bankruptcy trustee may avoid the January 10th transfer under section 547(b) to "facilitate the prime bankruptcy policy of equality of distribution among creditors."

V. WHAT DOES A PREFERENCE ANSWER LOOK LIKE?

The Answer filed by the preference Defendant must first be *timely*, in order to avoid the consequences of a default judgment. Secondly, it must deny, or join issue with some or all of the elements of the Trustee's *prima facie* case. Finally, the Answer must plead the affirmative defenses (*i.e.* so-called "yes, but ..." or confession-and-avoidance defenses) made available by the Bankruptcy Code which fit the facts and can be proved with admissible evidence to be presented by

the Defendant under the applicable Rules of Evidence when the preference case comes to trial. See Exhibit "B" hereto.

VI. AFFIRMATIVE DEFENSES

1. Contemporaneous Exchange

Section 547(c)(1) of the Bankruptcy Code precludes the avoidance of a transfer to the extent that such transfer was:

a. intended by the debtor and the creditor to or for whose benefit such transfer was made to be a contemporaneous exchange for new value given to the debtor; and

b. in fact a substantially contemporaneous exchange.

The so-called "contemporaneous exchange" defense was first delineated in *Dean v. Davis*, 242 U.S. 438 (1917), and later codified in Section 547(c)(1) of the Bankruptcy Code. "The justification for this exception is that transferring [property] in exchange for an infusion of [new property] does not harm existing creditors because it does not diminish the debtor's net assets." *Pine Top Insurance Co. v. Bank of America*, 969 F.2d 321, 324 (7th Cir. 1992). Also, Section 547(c)(1) strives to encourage transactions with beleaguered debtors by excluding from avoidance certain types of cash transactions. Stated differently, the contemporaneous exchange defense generally is not applicable to credit transactions.

TIMING OF PAYMENT BY CHECK

Trustee's Case:	Payment within 90 days?	Date of honor
Affirmative Defense:	Contemporaneous exchange?	Date of delivery

In each case, the rule favors the party with the burden of proof.

2. Ordinary Course of Business

Section 547(c)(2) of the Bankruptcy Code has been revised by the 2005 Act and now precludes the avoidance of a transfer to the extent such transfer was:

a. in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee; and

EITHER

b. made in the ordinary course of business or financial affairs of the debtor and the transferee;

OR

c. made according to ordinary business terms.

The former version of this defense had an "and" in place of the "or" above, necessitating proof of all three elements. Now, the creditor must prove only two elements, and can prevail on the defense by either focusing on the "subjective" specifics of the immediate relationship of the parties, or on the "objective" industry standard for the type of business under scrutiny. "The purpose of this exception is to leave undisturbed normal financial relations, because it does not detract from the general policy of the preference section to discourage unusual action by either the debtor or his creditors during the debtor's slide into bankruptcy." H.R.Rep. No. 595, 95th Congress, 1st Session 373 (1977).

3. New Value Defense

Section 547(c)(4) of the Bankruptcy Code precludes the avoidance of a transfer to the extent that, after such transfer, such creditor gave new value to or for the benefit of the debtor–

a. not secured by an otherwise unavoidable security interest; and

b. on account of which new value the debtor did not make an otherwise unavoidable transfer to or for the benefit of such creditor.

The Section 547(c)(4) defense "most obviously applies to revolving credit arrangements." "Protecting the creditor who extends 'revolving credit' to the debtor is not unfair to

the other creditors of the bankruptcy debtor because the preferential payments are replenished by the preferred creditor's extensions of new value to the debtor." *Laker v. Vallette*, 14 F.3rd 1088, 1091 (5th Cir. 1994). Section 547(c)(4) is intended to encourage creditors to deal with troubled businesses in the hope of rehabilitation.

4. Statute of Limitations

Bankruptcy Code § 546(a)

(a) An action or proceeding under section 544, 545, 547, 548, or 553 of this title may not be commenced after the earlier of--

(1) the later of--

(A) 2 years after the entry of the order for relief; or

(B) 1 year after the appointment or election of the first trustee under section 702, 1104, 1163, 1202, or 1302 of this title if such appointment or such election occurs before the expiration of the period specified in subparagraph (A); or

(2) the time the case is closed or dismissed.

5. Forward Contracts.

Bankruptcy Code § 546(e)

(e) Notwithstanding sections 544, 545, 547, 548(a)(1)(B), and 548(b) of this title, the trustee may not avoid a transfer that is a margin payment, as defined in section 101, 741, or 761 of this title, or settlement payment, as defined in section 101 or 741 of this title, made by or to a commodity broker, forward contract merchant, stockbroker, financial institution, *financial participant*, or securities clearing agency, that is made before the commencement of the case, except under section 548(a)(1)(A) of this title.

In much the same way that secured creditors are a "favorite" of bankruptcy law, forward contracts and forward contract merchants also receive "favored" treatment under the Bankruptcy Code. This is because a legislative policy decision was made to protect the financial stability of contract counterparties who participate in the complex web of interrelationships that make up the forward contract trade in particular industries, such as energy. Various black-letter rules of bankruptcy which present serious obstacles to the typical commercial creditor are inapplicable in the context of forward contract transactions. Payments by or to a forward contract merchant under a forward contract are immune from preference recovery, even if they would otherwise meet the test for a preference.

Bankruptcy Code § 101(25) and (26)

(25) *The term* "forward contract" ~~means a contract~~ means—

(A) *a contract* (other than a commodity contract) for the purchase, sale, or transfer of a commodity, as defined in section 761(8) of this title, or any similar good, article, service, right, or interest which is presently or in the future becomes the subject of dealing in the forward contract trade, or product or byproduct thereof, with a maturity date more than two days after the date the contract is entered into, including, but not limited to, a repurchase transaction, reverse repurchase transaction, consignment, lease, swap, hedge transaction, deposit, loan, option, allocated transaction, unallocated transaction, ~~or any combination thereof or option thereon;~~ *or any other similar agreement;*

(B) any combination of agreements or transactions referred to in subparagraphs (A) and (C);

(C) any option to enter into an agreement or transaction referred to in subparagraph (A) or (B);

(D) a master agreement that provides for an agreement or transaction referred to in subparagraph (A), (B), or (C), together with all supplements to any such master agreement, without regard to whether such master agreement provides

for an agreement or transaction that is not a forward contract under this paragraph, except that such master agreement shall be considered to be a forward contract under this paragraph only with respect to each agreement or transaction under such master agreement that is referred to in subparagraph (A) (B), or (C); or

(E) any security agreement or arrangement, or other credit enhancement related to any agreement or transaction referred to in subparagraph (A), (B), (C), or (D), including any guarantee or reimbursement obligation by or to a forward contract merchant or financial participant in connection with any agreement or transaction referred to in any such subparagraph, but not to exceed the damages in connection with any such agreement or transaction, measured in accordance with section 562.

(26) *The term* "forward contract merchant" means a ~~person whose~~ *Federal reserve bank, or an entity the* business *of which* consists in whole or in part of entering into forward contracts as or with merchants in a commodity; (as defined in section 761~~(8) of this title,~~) or any similar good, article, service, right, or interest which is presently or in the future becomes the subject of dealing in the forward contract trade.

The determination of what constitutes a forward contract is still an imprecise art rather than an exacting science. The statutory provisions and the caselaw which has developed under them to date leave a great deal of uncertainty (and room for creativity!) putting creditors at risk who assume too much about the legal status of their agreements.

One of the most encouraging of the recently reported decisions originated in Bankruptcy Court here in Houston and was affirmed on appeal to the federal Fifth Circuit, namely, *In re Olympic Natural Gas Company,* 258 B.R. 161, 164-65 (Bankr. S.D. Tex. 2001), *aff'd* 294 F. 3d 737 (5th Cir. 2002). See Memorandum attached hereto as Exhibit "C" prepared by this presenter for the *Bethlehem v. Superior* case.

However, not all Bankruptcy Courts have been embracing forward contracts and forward contract merchants with open arms. In *Aurora Natural Gas, LLC, v. Texas Eastern*

Transmission Corporation, et al., 316 B.R. 481 (Bank. N.D. Tex. 2004), Aurora's Chapter 7 Trustee brought an adversary proceeding to avoid a pre-petition payment to Duke Energy Field Services. Duke moved for summary judgment under Section 546(e) of the Bankruptcy Code set forth above. The Bankruptcy Court denied Duke's motion because it held that a genuine issue of material fact existed to be tried in a full-blown evidentiary proceeding concerning whether Duke acted as a forward contract merchant or instead as a debt collector when it engaged in activities to collect amounts owed to it by Aurora. The Bankruptcy Court suggested that if Duke was acting as a debt collector, and not a forward contract merchant, then Duke may not be entitled to "safe harbor" protection.

This decision comes shortly after the holding in *Mirant Americas Energy Marketing, L.P. v. Kern Oil & Refining Co.*, 310 B.R. 548 (Bank. N.D. Tex. 2004), where the Bankruptcy Court rejected Kern Oil & Refining Company's suggestion that it was entitled to be treated as a forward contract merchant simply because it entered into a forward contract in connection with its business.

These two recent cases interpret the term "forward contract merchant" in a way that appears to be more limiting than what the statutory definition alone provided. However, the new statutory definition may obviate this trend because it is *looser* and *broader*.

Moral: **It ain't a forward contract until the Bankruptcy Judge says it's a forward contract.**

VII. CONCLUSION

By being alert to pre-bankruptcy danger signals, you may be able to protect yourself from a preference problem. However, when preference issues do arise, you should not assume that any money you received during the last ninety days before bankruptcy must be returned. By

contesting the Trustee's case or invoking the available statutory affirmative defenses, you may be able to defeat the preference case, or at least enhance your leverage for compromise negotiations. Since this material has been edited and abbreviated for educational purposes, it should not be relied upon as definitive or as legal advice. Consult a Creditors' Rights Specialist with expertise and experience in these matters any time you are confronted with a preference problem or issue in your business or credit world.

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