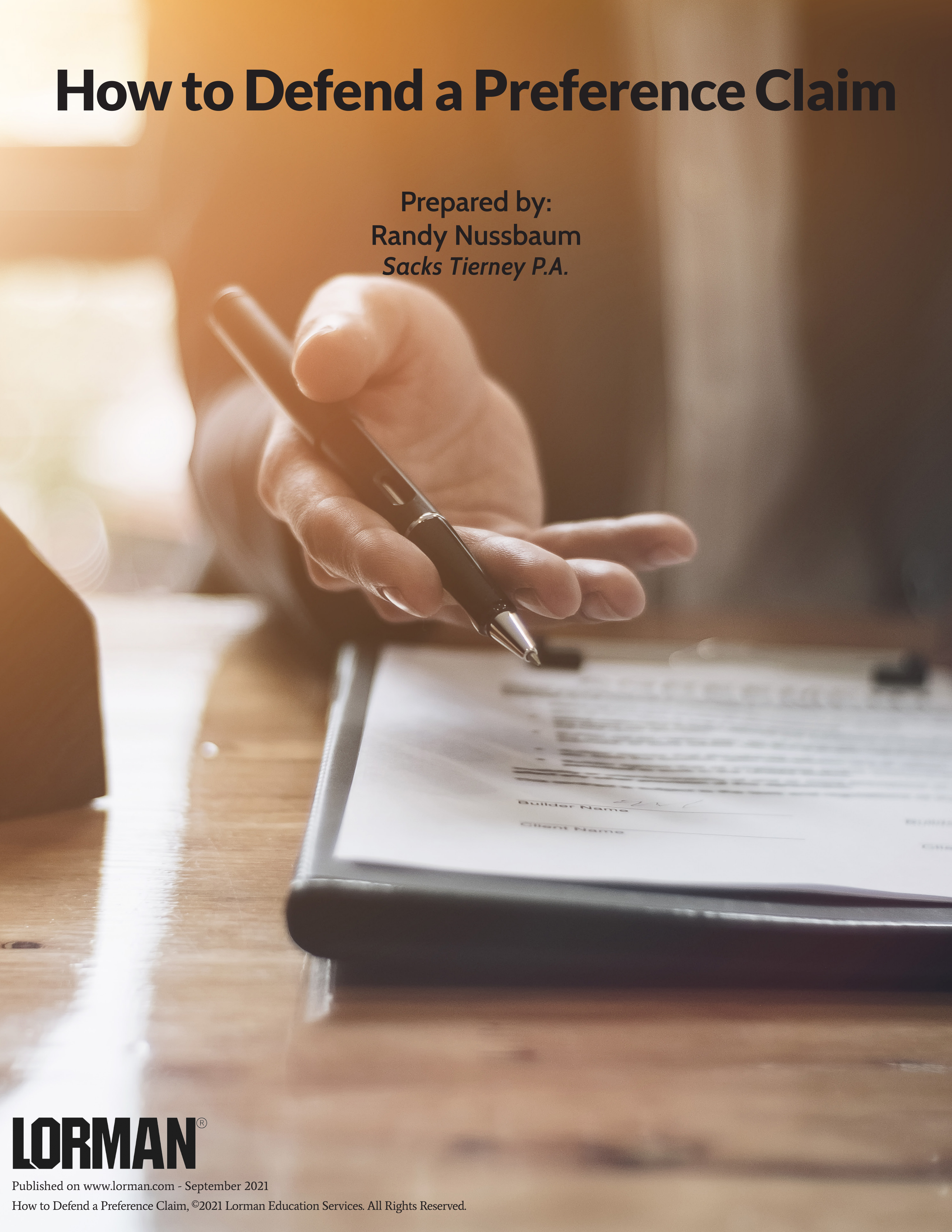
How to Defend a Preference Claim



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HOW TO DEFEND A PREFERENCE CLAIM

Certain payments made on account of an antecedent debt are not preferences based on Section 547(c). However, for purposes of this material, any position that could be advanced to defeat a preference claim will be identified as a defense.

A. Insider versus non-insider

What constitutes an insider is determined both by referring to the statutory definition of an insider found in Bankruptcy Code Section 101 (31) and through case law. It is up to judicial determinations as to when a potential defendant possesses all the requisite characteristics to still be an insider even though not specifically identified under the statute.

The vast majority of the controversy revolves around non-statutory insiders for the obvious reason that it is relatively easy and straightforward to identify who or what falls within the purview of the statutory definition.

Defendants who have been determined to be insiders even though their volition falls outside the statutory definition include:

- Both company that was spun off from debtor and company's owner, a friend of the debtor's principal, were found to be non-statutory insiders. *In re Bruno Machinery Corp.*, 435 B.R. 819 (Bankr. N.D. N.Y. 2010).
- Corporation wholly owned by Chapter 7 debtor's father was non-statutory insider based on lack of arm's length transactions. *In re Smith*, 535 B.R. 374 (Bankr. D. Colo. 2015).Long-time accountants that assisted corporate debtor's management in concealing debtor's insolvency, thereby allowing debtor's insolvency to deepen, exercised sufficient

control over debtor to qualify as non-statutory insiders. *In re TS Employment, Inc.*, 603 B.R. 700, 703 (Bankr. S.D.N.Y. 2019).

No hard and fast rules exist to differentiate an insider from a non-insider outside of the statutory definition. This of course makes sense when you use an example of an ex-spouse since certain ex-spouses would constitute an unequivocal non-insider, whereas other ex-spouses could very well possess certain knowledge and information which in certain instances elevates them to a party having far more "insider" information than even most statutory insiders. Whether a transferee is considered a non-statutory insider depends on the closeness of the relationship with the debtor and whether the transaction is truly arms-length. *In re The Village at Lakeridge, LLC*, 814 F.3d 993 (9th Cir. 2016).

B. <u>Contemporaneous Exchange for New Value</u>

A potential debtor who engages in a contemporaneous exchange even the day before bankruptcy is not engaging in the type of activity that the Bankruptcy Code is designed to discourage and to rectify under preference law. If a third party is providing a contemporaneous exchange for new value equivalent to the payment being made by the debtor, this conduct is not offensive in any manner and is not prioritizing one creditor over another. The purpose of the contemporaneous exchange for new value defense is to encourage creditors to continue to deal with financially distressed debtors as long as their transactions involve true exchanges of equally valued consideration. Of course, this leaves to be determined what is a contemporaneous exchange. The critical inquiry in determining whether there has been a contemporaneous exchange for new value is whether the parties <u>intended</u> such an exchange. *In re Wadsworth Bldg. Components, Inc.*, 711 F.2d 122, 124 (9th Cir.1983). The following are examples of what are considered to be contemporaneous exchanges.

- Fourteen-day delay in perfection was a substantially contemporaneous exchange, so long as the delay can be satisfactorily explained. *In re Marino*, 193 B.R. 907 (9th Cir. B.A.P. 1996), aff'd 117 F.3d 1425 (9th Cir. 1997).
- Payments to subcontractors from general contractors. *In re JWJ Contracting Co., Inc.*, 287 B.R. 501 (9th Cir. B.A.P. 2002).

Rents paid a few days after the first of the month are contemporaneous exchange for new value for purposes of exception to trustee's avoidance powers since statute requires only that payments be "substantially contemporaneous." *In re Garrett Tool & Engineering, Inc.*, 273 B.R. 123 (E.D. Mich. 2002).

- Additional labor, equipment, and materials that subcontractor provided, on unsecured basis, after receiving payment from general contractor debtor was in nature of contemporaneous exchange for new value. *In re Modtech Holdings, Inc.*, 503 B.R. 737, 751 (Bankr. C.D. Cal. 2013).
- Late rent which Chapter 7 debtor paid to its commercial landlord, in same month that rent was due (28 days late), was in fact substantially contemporaneous with new value that lessor provided in allowing debtor to occupy premises. *In re JS & RB, Inc.,* 446 B.R. 350 (Bankr. W.D. Mo. 2011).

C. Ordinary Course Payments

The law has evolved over the years in favor of the preference defendant. Currently, a defendant can either argue that the payments made by the debtor were in the ordinary course pursuant to industry standards or the payment was within the ordinary course based upon the past dealings between the debtor and the payment recipient. Without question, allowing either of these defenses to defeat a preference claim shows that a creditor is not at risk of receiving a pre-bankruptcy payment if the payment is consistent with what that party had been receiving over an extended period or was within industry standards. Not surprisingly, both the prior course of business defense and the consistency with industry standards defense are regularly litigated.

For example, if the debtor ordinarily paid the creditor 20 days from the billing, but the industry standard is that the payment would be made within 30 days and the debtor then makes a payment to the creditor 38 days after the billing, would this payment be preferential? A review of the case law does not provide specific guidance, though as a general proposition, the Bankruptcy Court is normally trying to ascertain whether the payment really was preferring one creditor over the others and whether the payment is inconsistent with the general course of dealings between the parties over an extended period or what is normal in the industry.

D. Subsequent New Value

It is not unusual in many instances for a debtor making a large payment on account of even past due debts to convince the third-party creditor to extend additional credit to the debtor in the form of services or product. When that occurs, because it is inherently unfair for that creditor to then not get paid for the new value extended while having to return what may have been paid within the preference period, the Bankruptcy Code normally allows a creditor to set off the amount of new credit extended after the preferential payment for equitable reasons. As a practical matter, in such instances, the creditor is not receiving any type of benefit because if the creditor receives $20,000 on account of an antecedent debt right before bankruptcy and then extends $20,000 of credit to the debtor shortly thereafter, the creditor is out the same $20,000 that it would have been if it had never received the preferential payment.

E. Debtor was Solvent

If you can prove the debtor was solvent when the payment was made, the payment would not be a preference.

F. Preference Standard Under the Small Business Reorganization Act (SBRA)

Under SBRA, the trustee can only pursue such a claim

> …based on reasonable due diligence in the circumstances of the case and taking into account a party's known or reasonably knowable affirmative defenses under (c)….