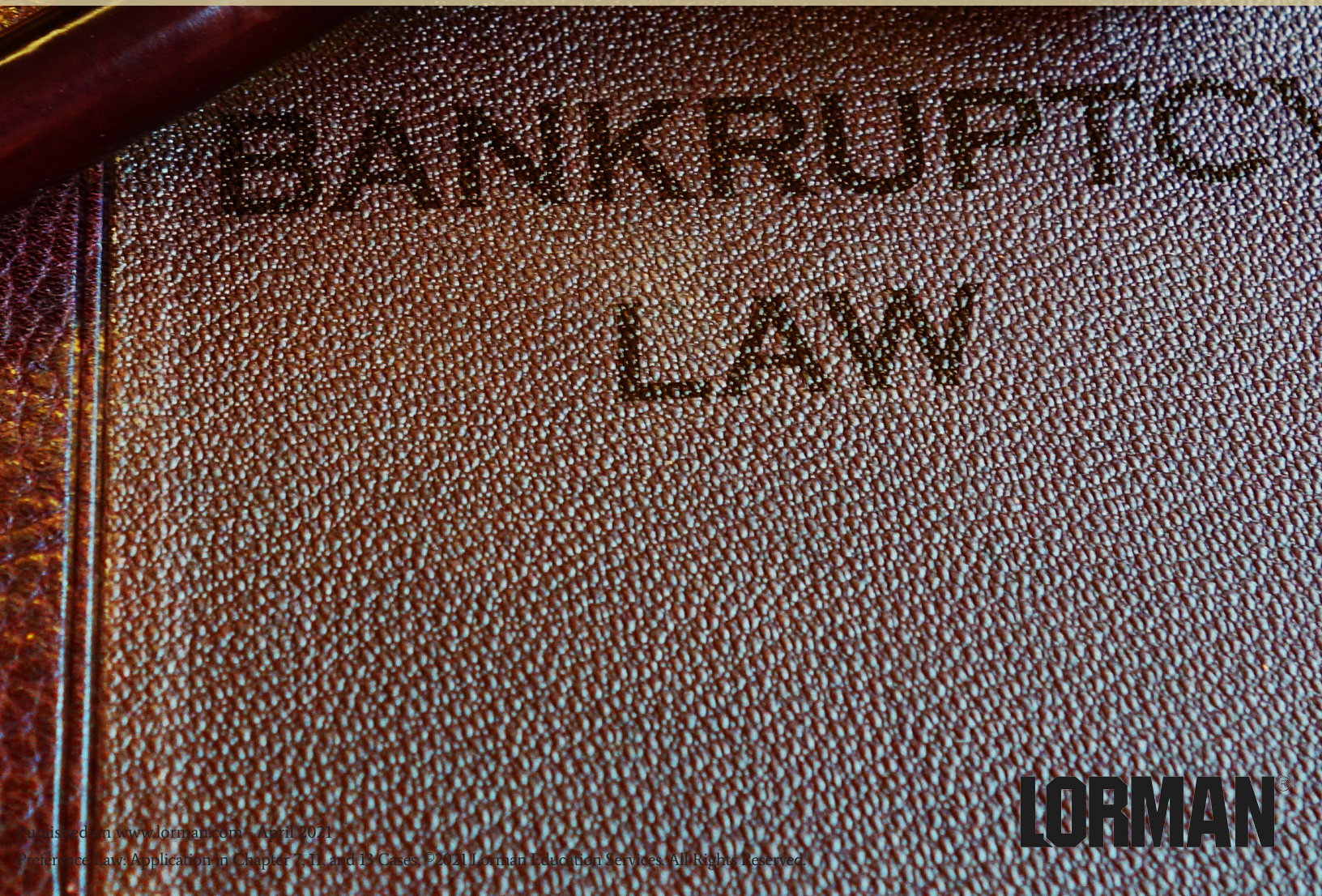




Preference Law: Application in Chapter 7, 11, and 13 Cases

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PREFERENCE LAW

by Randy Nussbaum

I. INTRODUCTION

The vast majority of preference law is unique to the Bankruptcy Code. Though in certain instances an aggrieved creditor can bring a claim under state law when that creditor's debtor prioritizes payments to third parties, the ability to do so is very difficult and subject to relatively strict statutory and judicial parameters. On the other hand, recovering preferential payments in bankruptcy is far easier than under state law because the Bankruptcy Code provides specific statutory authority to recover such payments. Preferential payments are recoverable in bankruptcy court because of the legislative desire that creditors in the same class be treated equally. In principle, this legislative desire is commendable and should prevent a debtor from "gaming" the system by paying off preferred creditors. Simultaneously it ensures that creditors who are willing to work with the debtor are not unfairly penalized by their cooperation. Understandably, from the perspective of a defendant facing a preference claim, this statutory power can be extremely frustrating.

The pertinent statute is 11 U.S.C. § 547. In simplest terms, a payment made on account of an antecedent debt by the debtor within 90 days of bankruptcy is recoverable by the bankruptcy trustee or, in the case of a Chapter 11, by the debtor-in-possession. When the payment is made to an insider, because of the basic premise that an insider is fully aware of the debtor's financial condition, the payment is recoverable if made within one year of the bankruptcy filing. On its face, all of this is rather straightforward, but further review quickly demonstrates that it is not.

Section 547 applies in all forms of bankruptcy, be it Chapter 7, 11, or 13*. Nevertheless, there are some practical differences in how preference claims are pursued depending upon the bankruptcy Chapter.

II. APPLICATION IN CHAPTER 7, 11, AND 13 CASES

In a Chapter 7 case, an independent trustee is assigned to administer the bankruptcy estate, and that trustee, normally through counsel, is charged with the responsibility of recovering any preferential payments. Though the Chapter 7 debtor is obligated to provide the trustee with the relevant disclosure regarding such payments, once that information is disseminated to the Chapter 7 trustee, it is the trustee's sole responsibility to pursue the claim. A Chapter 7 trustee is compensated based on a percentage of the amount of assets distributed to creditors.

In a Chapter 13 case, similar to a Chapter 7 case, the assigned trustee is also responsible for pursuing the preference claim. However, an important distinction is that Chapter 13 trustees do not have the same incentive to pursue preference claims because they are paid a percentage of what the Chapter 13 debtor pays through the Plan of Reorganization. The recovery of a preference could in many instances result in an increased dividend to unsecured creditors and therefore more money for the trustee, but Chapter 13 trustees simply don't have the incentive or necessarily the inclination to devote substantial attention to such recoveries.

As a result, it has been my experience that Chapter 13 trustees are less inclined to pursue such a recovery, and in many instances, if the Chapter 13 debtor is willing to voluntarily incorporate into the Plan payment in an amount

* This outline will not address the relatively rarely used Chapter 9 or 12.

sufficient to cover a significant portion of the preferential payment, the matter will not be pursued.

This is not to suggest that a Chapter 13 trustee will not try to recover a significant preferential payment that was made by a Chapter 13 debtor, but a quick review of the bankruptcy docket and published opinions will confirm that Chapter 13 trustees normally are not participants in litigation of this type.

In a Chapter 11, the debtor-in-possession has the statutory powers of a trustee and has the absolute obligation to creditors to recover any such amounts. In most cases, the debtor-in-possession will do so. Since the settlements are subject to Court approval, the ultimate disposition must be in the best interests of the bankruptcy estate and the creditors. In some Chapter 11 cases, the confirmed Plan will provide for an independent liquidating trust to recover such amounts. In many instances this makes sense because the debtor-in-possession is focusing on other aspects of the Chapter 11 and may not be the appropriate party to pursue any such recoveries.

In certain instances, the Chapter 11 case does not justify the appointment of a separate entity to pursue the preferences and the debtor refuses to do so. In these cases, the debtor's inaction constitutes grounds for conversion, dismissal, or even the appointment of a Chapter 11 trustee to step in.

III. HOW PREFERENCES ARE PURSUED

Pursuing the recovery of a preferential payment requires the filing of a separate adversary proceeding. The trustee has the later of two years from the petition date or one year from the date of his/her appointment to bring the adversary complaint. In converted cases where the trustee is appointed in the second year, the trustee still has one year from being appointed to bring the adversary.

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 placed restrictions on when and where a debtor can pursue preferences. In a business case, the claim cannot be pursued unless the amount involved is at least \$6852 and when the claim is less than \$25,000, the action must be brought in the district in which the defendant resides. These specific changes were implemented, correctly, because, in multi-preference litigation cases, preference defendants would many times write nuisance value settlement checks because they could not afford the cost of defense or to travel to the district in which the action was brought. Since legal fees are not recoverable in preference litigation except in rare instances under a Rule 11 violation, limiting where preference litigation could be brought was the best solution to a rather inequitable situation.

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