

A PREFERENCE THAT NO ONE PREFERS: LIABILITY FOR PREFERENCE PAYMENTS UNDER THE BANKRUPTCY CODE



MATT RICH

“Why am I being sued? I didn’t do anything wrong!” That’s a common sentiment from many clients who find themselves on the wrong end

of a bankruptcy preference action.

With economic conditions worsening, this is becoming an all-too-frequent phenomenon and one that you may need to understand going forward. This article will set out the basic elements of a preference claim, how to avoid preference liability, and the available defenses to preference liability if a claim has been filed against you.

A preference claim covers any transfer of cash or other property by the bankrupt debtor to a creditor or third party in the 90 days prior to the filing of the bankruptcy petition, so long as the cash or property is intended to pay a debt that existed prior to the transfer.

The Preference Claim

While there are a number of potential claims that a trustee or debtor-in-possession may assert to recover money paid out by a bankrupt company to a creditor, the most common is the preference claim. A preference claim covers any transfer of cash or other property by the bankrupt debtor to a creditor or third party in the 90 days prior to the filing of the bankruptcy petition, so long as the cash or property is intended to pay a debt that existed prior to the transfer.

It is called a preference claim because the debtor is treated as having been insolvent for the 90 days leading up to the filing of the petition, and any payment made during this period is treated as evidence that the insolvent debtor has “preferred” the creditor receiving the payment to the detriment of all other creditors. Since one goal of the bankruptcy system is to ensure that creditors receive an equitable and proportional distribution, the preference claim allows the debtor to recover those preferential payments to fund a more proportional distribution to the creditors of the bankrupt estate.

Defendants often struggle with being named in a preference lawsuit, but you should know that it is no indication of wrongdoing whatsoever. The bankruptcy rules are very mechanical, and the preference rules apply regardless of the presence or absence of intent to violate them.

Avoiding Preference Liability

The best defense to a preference action is not to be involved in one at all. The next best is to position yourself to take advantage of the preference defenses discussed below.

A helpful place to start is performing routine credit checks, not only for new customers, but also for customers who seem to be struggling. This may alert you to the need to treat with the customer on CASH or C.O.D. terms, which, as set forth below, will give you a defense to preference liability. Another strategy may be to analyze the payment history and try to ensure that payment is received on a consistent schedule with past payments, which could set up another defense. This strategy is less surefire and may be tricky to administer, but it is something to consider.

Other than strategies that set up potential defenses, a creditor has little control over whether a preference action will be filed. In terms of preparing for potential preference actions, it may make sense to track payments made by companies that are potentially insolvent so that you can determine which payments are no longer at issue (i.e., which are safely outside the 90-day window).

If it is financially feasible, it may also be wise to set aside roughly one-half of the amount received until the preference period passes, so that there is a settlement fund in the event of a claim or suit. Most preference actions settle for a fixed percentage of the total claim, and having this fund could be helpful in facilitating settlement.

Defenses to Preference Liability

So what happens if a preference claim is filed? Well, you should probably contact us to evaluate your potential defenses.

There are a number of defenses to preference liability that are set out in 11 U.S.C. § 547(c). The three that arise most frequently are referred to as the “ordinary course defense,” the “new value defense” and the “subsequent advance defense.”

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Under the ordinary course defense, a transfer made in the ordinary course of business between the debtor and the creditor and made pursuant to ordinary business terms cannot be recovered by the debtor as a preferential transfer. To determine whether the transfer is ordinary in the course of the relationship between the debtor and creditor, it is necessary to examine the parties' payment history (often going back as far as two to three years).

The important information is the number of days between the invoice and the payment, as this number will be compared with the number of days between the invoice paid during the preference period and the claimed preference payment. Thus, if a debtor had historically paid within 43 days of the invoice, but paid during the preference period within 11 days (or 111 days), the payments are not likely to have been made in the ordinary course of dealing between the parties and the defense will not apply. Additionally, the payment must be ordinary in the industry, as determined by prevailing industry standards.

The new value defense applies to situations in which the payment by the debtor is substantially contemporaneous with the creditor providing new value (in the form of money or goods/services). Shipments of goods with CASH or C.O.D. terms are classic examples of new value. The term "substantially contemporaneous" does not mean that the exchange has to happen simultaneously; it is enough if the parties intended the exchange to be contemporaneous. Thus, a gap of a few days between the payment and the exchange of the goods should be permissible if the parties intended the two to be substantially contemporaneous.

CHAMBERS USA RECOGNIZES KATZ TELLER

The *Chambers USA* 2008 guide of top lawyers and law firms was released recently, and Katz Teller was again recognized in the areas of corporate law and litigation. The Chambers' rankings are independent and objective, and – as the guide itself notes – "no one can buy their way in."

The 2008 guide had this to say about Katz Teller's corporate/mergers & acquisitions department:

"This 'excellent' Cincinnati firm fields a strong corporate M&A group reputed as being 'assertive, methodical and very good at what they do.' The lawyers focus their attention on handling smaller transactions for private companies, and have recently

The final major defense to preference liability is the subsequent advance defense, which applies when a creditor provides new value (again, typically money, goods or services) after the receipt of a transfer from the debtor, and for which the creditor remains unpaid. The theory here is that the creditor has enriched the debtor's estate by providing the new value, and so should be allowed to offset that new value against the preference liability.

For example, if the debtor pays \$30,000 for old invoices (a preferential transfer unless the ordinary course defense applies), and 22 days later the creditor ships \$20,000 in new goods for which it never receives payment from the debtor, the creditor is then entitled to deduct that \$20,000 from the \$30,000 preference liability.

A strange wrinkle of this rule is demonstrated by the following example: if a creditor ships \$40,000 worth of goods and not \$20,000 as in the example above, then the preference liability is wiped out, but the \$10,000 does not carry over. Thus, if another preference payment is made eight days after the provision of goods, the creditor will owe the full amount of the preference, and will not be able to apply the \$10,000 to that claim (because the new value was not provided subsequent to that preference payment).

We know that preference actions can be complex and frustrating for creditors, but we can help. Please feel free to contact us if you have questions or need assistance navigating the preference litigation process.

assisted foreign-owned strategic buyers interested in acquiring private U.S. businesses." Mark Jahnke was identified individually as "a phenomenal and business-savvy lawyer."

The Katz Teller litigation department garnered similar praise:

"Although a smaller operation, this Cincinnati-based outfit is judged 'a fine firm,' and in the past year has tackled litigation issues in the corporate antitrust, trust, securities and healthcare areas." Bob Pitcairn was recognized by interviewees for his "exceptional trial style" and "wide range of generalist legal and corporate litigation skills."

INSIDE KTBH

Andy Berger will be speaking at 6:00 p.m. on October 16, 2008, about "The State of Medicine" at the Kenwood Country Club, 6501 Kenwood Road. Topics to be covered include considerations when comparing private practice to hospital employment, the Healthcare Simplification Act, news regarding tort reform legislation, and the impact of the 2008 election on taxation, investment markets and the healthcare industry.

Jerome Bishop was elected as a shareholder of Katz Teller starting January 1, 2009. Jerome has been with Katz Teller since March of 2003 as an associate attorney in the litigation department.

Jody Brant was interviewed by Barbara Keller of CET regarding planned giving. Jody is a member of the CET planned giving committee.

Cynthia Gibson has been selected to speak at the National Labor and Employment Law Conference of the Society for Human Resource Management ("SHRM") in Washington, D.C. Her presentation will be "Electronic Discovery Rules: Why HR Professionals Should Care." SHRM is the world's largest professional association devoted to human resource management.

Laura Hinegardner has been elected secretary of the board of the Fort Thomas Education Foundation and is a member of the board's Executive Committee. The Foundation exists to support the students, faculty and staff of Fort Thomas Independent Schools by funding educational programs and activities that exist outside the district's operating budget.



Mark Jahnke has been elected to serve as a member of the board of directors of United Way of Greater Cincinnati.

Wijdan Jreisat was recognized by the *Business Courier* as a member of its 2008 Forty Under 40. The program identifies and recognizes the tristate's up-and-coming business, community and economic leaders. Wijdan also completed Leadership Cincinnati, a program of the Cincinnati USA Regional Chamber.

Tara Klee and **Mark Jahnke** represented a local pet food and pet supplies distribution company in a sale to a Pennsylvania-based strategic acquirer.

Reuven Katz and his wife, Cate, celebrated their 60th wedding anniversary this summer.

Matt Rich was appointed to the Regional Youth Leadership Law Day Committee to oversee and coordinate the program's mock trial component. Regional Youth Leadership is a leadership development program that informs, motivates and increases the awareness of selected high school juniors through issue-oriented seminars and interaction with community decision makers.



MEET MATT KITCHEN | KTBH ASSOCIATE



Matt Kitchen is a native Central Ohioan who now proudly claims Cincinnati as his adopted hometown. Born and raised in Lancaster, Ohio, Matt knew that he wanted to practice law from a fairly young age.

Despite being the son of two Ohio State graduates and having a strong allegiance to the Buckeyes, Matt chose to attend Miami University, where he planned to pursue a degree in history or political science as the next step on his road to law school. After taking an introductory-level business class, however, he became interested enough in the school's business program to consider a change in plans. It didn't hurt that accounting students were in high demand as accounting and consulting firms prepared for the impending Y2K disaster. So, Matt chose to major in accounting, with a minor in management information systems.

Following graduation from Miami, Matt accepted a position as an auditor with a public accounting firm in Columbus. The experience provided Matt with a wonderful introduction to the business world and afforded him the opportunity to work with a wide variety of clients, from manufacturers and distributors to nonprofit entities and universities.

In the fall of 2000, Matt was engaged to Lauren, a Lancaster native and Miami alumna, who had taken a job with Marsh & McLennan in Cincinnati. Matt decided that he could probably move away from Central Ohio "temporarily," and began interviewing for jobs in Cincinnati. In the process, a recruiter sent Matt to interview with a large bank based in town for a position in its commercial lending audit department. While the job was a significant departure from the work that he had been doing in Columbus, the challenge that it presented and the opportunity to add to his business skill set were too good for Matt to pass it up. For more than two years, Matt contributed to the bank's credit process by visiting existing and prospective customers to gain a more in-depth understanding of their financial conditions and operations.

Cincinnati quickly grew on Matt, as he discovered everything that the city had to offer and renewed his interest in the Reds and Bengals. Although he was truly enjoying his work with the bank, Matt's interest in law began to reemerge. As always, Lauren (now his wife) was supportive and encouraged Matt to attend law school.

Matt enrolled at the University of Cincinnati College of Law in the fall of 2003 and found that the business experience he gained while deferring law school was extremely beneficial. During his time at UC, Matt focused on the business curriculum and was selected as a Corporate Law Fellow for his interest and accomplishments in the field of study. Additionally, two of Matt's corporate law articles were selected for publication in the *University of Cincinnati Law Review*. During his third year of law school, Matt was elected managing editor of the law review and was honored as the co-recipient of the law review prize for the most significant contribution to the organization for his efforts in redesigning and managing the article selection process.

As an associate at Katz Teller, Matt assists clients in a variety of business and real estate matters, including entity formation, acquisitions, divestitures, contract drafting and review. Employing his past experience to help clients solve their business and legal issues is the most satisfying part of the job for Matt.

Lauren and Matt have lived in Walnut Hills for more than seven years and enjoy the proximity to Eden Park and downtown Cincinnati. Their lives were drastically changed for the better by last year's arrival of their son, Glen, who is never short on energy. Outside of work, Matt enjoys athletic events, hiking and working on projects around the house (despite his total lack of home improvement skills). Matt has served on several committees at St. Francis de Sales and is currently a member of its parish council.

Katz Teller is very excited to have Matt on board!

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