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Preference Avoidance

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Editor's Note: *In an earlier installment of this column, the editors offered a sketch of the "avoiding powers." These powers enable the debtor to "avoid" (invalidate, rescind or unravel) certain transactions that might, absent bankruptcy, have been valid and binding as between the debtor and the transferee.*

We began to discuss preference avoidance in our prior overview of avoidance powers. In this installment, we discus preferences in a bit more detail. Recall that, generally speaking, §547 allows the debtor to avoid a transfer to a creditor for an antecedent debt, made while the debtor was insolvent, if the transfer would allow the transferee to get more than he would get in a chapter 7.

To understand preference law, turn your Code to §547(b), which sets forth the *prima facie* case (subsection (a) includes a couple of definitions). If your case meets the affirmative elements of a preference under subsection (b), then you look at whether any of the exceptions, which are listed in §547(c), apply. Then you track through the rest of the statutes (and case law) to identify nuances and qualifications.

Here is the *prima facie* case:

- Transfer is made to or for the benefit of a creditor
- Transfer is made on account of an antecedent debt (that is, a debt that existed prior to the time of the transfer), made while the debtor was insolvent (there is a rebuttable presumption of insolvency for the 90-day period prior to the bankruptcy filing)
- Made within 90 days prior to the bankruptcy filing date, or one year if the transferee was an insider ("insider" is defined in §101(31) of the Bankruptcy Code)
- Transfer has enabled the recipient to receive more than he would have received if the transfer had not been made and the debtor were liquidated under chapter 7.

Some examples show how this can work:

1. *Vendor supplies widgets to the debtor.* Prior to the petition date, the debtor has not been paying the vendor, but the vendor—hoping the situation is temporary—continues to ship widgets. Finally, the vendor gets fed up and tells the debtor it will stop shipping if the past-due balance isn't paid immediately. The debtor pays the back-due balance, and 30 days later it files a bankruptcy petition. This is likely a preference.

2. *Same situation as above, but the debtor did not file for bankruptcy until 91 days after the payment to the vendor.* This would not be a preference, unless the vendor were an insider, since the preference look-back period is 90 days.

3. *The debtor owes unsecured debt to the lender.* The lender is nervous that the debtor is insolvent, and the lender fears that the debtor may default on the loan. To appease the lender, the debtor grants the lender a mortgage on the debtor's headquarters building. Three weeks later, the debtor files for bankruptcy. No payments are involved here, but the granting of the mortgage lien is a "transfer" on account of an "antecedent debt" and therefore likely avoidable as a preference.

4. *The debtor owes the secured lender $7 million, secured by all the debtor's real estate and accounts receivable.* These security interests are properly perfected, and the collateral is worth $12 million. The loan is in default, and the secured lender is threatening to foreclose, which would put the debtor out of business. So the debtor pays the $7 million and then, two days later, files for bankruptcy. Sounds like it might be a preference—but it's probably not. Because the secured lender is oversecured, it would be paid in full in a chapter 7 liquidation, and so the payment it received from debtor did not enable it to receive *more than* it would have received in a chapter 7. Consequently, there is no preference. The lesson is this: Pre-petition payments to fully secured creditors are not preferential.

These are relatively simple examples. Here's one that's a bit more complicated—but more common than you might imagine:

5. The debtor borrows $100 from Charlie and gives Charlie a security interest in the debtor's defenestrator. The debtor signs a UCC-1 financing statement, but Charlie forgets to file it in the public records. The debtor files for bankruptcy. The debtor (even though we use "debtor" throughout, this is technically wrong—it is the trustee or debtor-in-possession (DIP)) gets to avoid Charlie's security interest—but not as a preference. Rather, the debtor avoids it using his "hypothetical lien creditor" power under §544(a)(1). A lien creditor could have avoided this unperfected security interest at state law absent bankruptcy; the debtor steps into the shoes of the lien creditor and avoids the transfer.

6. The debtor borrows $100 from Charlie and gives Charlie a security interest in the debtor's defenestrator. The debtor signs a UCC-1 financing statement. Charlie forgets to file it. Months pass. Charlie discovers his error and then files the financing statement. The next day, the debtor, hopelessly insolvent, files for bankruptcy. Note that the trustee cannot avoid this transfer using his lien-creditor power, because he gets the rights of a lien creditor only as of the day of bankruptcy, and as of the day of bankruptcy, a lien creditor could not have avoided this (late-filed) transfer.

But wait. On these facts, the Bankruptcy Code (§547(e)(2)) provides that the giving of security is a transfer "made" only when "perfected," *i.e.*, when it was filed. And when it was made/perfected/filed, it was a transfer for an antecedent debt. So, it is avoidable as a preference. The lesson here is this: A late-filed security interest may be avoidable as a preference.

But that is not quite the end of it. §547(e) provides that a security interest is "made" when it is "perfected." But it also adds an extra fillip: a grace period for late filing. It provides that a security interest is made when it is *effective between the parties* if it is perfected within 10 days thereafter. Therefore:

1. On day 1, the debtor borrows $100 from the creditor, giving the creditor a security interest in his defenestrator. The debtor signs a financing statement, but the creditor forgets to file it until day 30. There is no grace period: The transaction is "made" at day 30.

2. Same as #1, except that the creditor files on day 9. The grace period kicks in: The transaction is "made" at day 1.

3. By contrast, on day 1, the debtor signs and the creditor files a UCC-1 financing statement. On day 9, the debtor borrows $100 from the creditor, giving the creditor a security interest in his defenestrator. The transaction is "made" at day 9. There is a grace period for late filing, but not for a late agreement.

There is actually a second "grace period" rule—this one is in §547(c), the "exceptions" section. Recall that §547(c) identifies several transactions that will not be avoidable—exceptions to the preference rules of §547(b). It applies to "purchase-money" transactions—the case of a seller who sells goods on credit, or the lender who finances the sale. The purchase-money creditor gets 20 days to complete the perfection of his security interest. If the holder of a purchase money security interest perfects within 20 days after the debtor receives possession of the property, it will not be a preference. This section dovetails with the 20-day grace period in §9-317(e) of the Uniform Commercial Code. Note that this purchase-money rule protects a seller or a lender only if there is a security interest. Without a security interest, we would expect the seller to find himself restricted to sharing with the other unsecured creditors. There is, as it happens, one thread of hope for the unsecured seller, although it is pretty thin—§546 (c). Section 546(c) preserves a seller's state law right to reclaim his goods from the bankruptcy estate. To do so, the seller must show that he had a right of reclamation at state law (refer to Uniform Commercial Code §2-702), and he must make a demand in writing within tight time limits.

There are a number of other "defenses" or "exceptions" to the preference laws in §547(c). Any time you have a preference case, it's a good idea to go through all the §547(c) provisions to see whether any of them might apply. We discuss a few of the more common ones below.

Section 547(c)(1) provides an exception for a "substantially contemporaneous exchange." This is easy enough to follow: The debtor takes delivery of a five-pound sack of birdseed; he passes to the seller a $5 bill. We can see why you don't want to treat this as a preferential transfer; the debtor gave as good as he got, and the estate is no worse off. Our example probably isn't a preferential transfer *at all* (where's the "antecedent debt?") and so not in need of an exception. But if the debt were created on day one and repaid two days later, and the parties intended the transaction to be a contemporaneous exchange, it should still qualify for the defense—even though technically the payment was for an "antecedent debt."

Another important defense is referred to as "subsequent new value." Consider this case: The debtor owes $100 to the creditor unsecured. Eighty-nine days before bankruptcy, the insolvent debtor pays the creditor in full. This looks like a preferential transfer. But now, suppose that 88 days before bankruptcy, the creditor lends the debtor another $100. Can the debtor avoid the payback that was made on day PD-89 (89 days before the petition date) as a preferential transfer? Section 547(c)(4) says "no." It provides that we won't avoid the first transfer where the creditor extends "new value" after it received a preferential repayment. If the new value is less than the amount of a preference payment, it does not eliminate the recipient's preference liability, but serves as an offset to the extent of the new value. There is some dispute among courts as to how subsequent new value credit should be calculated (*i.e.*, must the new value remain unpaid) that is beyond the scope of this general column, but you should review the different approaches if you have a case where this is an issue.

For another exception, consider the case where the debtor borrows $1 million from the creditor, secured by a perfected security interest in the debtor's inventory. The liquidation value of the inventory is $800,000 on that day. Thus, the creditor has an $800,000 secured claim and a $200,000 unsecured claim. The debtor continues in business, and 10 days later the debtor's inventory is worth $600,000. Twenty days after that the inventory is worth $1.5 million. A few days after that, on the day the debtor files for chapter 11, the inventory is worth $1.2 million. The creditor (assuming it is still owed $1 million on the petition date) has a secured claim of $1 million. But $200,000 of that is an avoidable preference. However, the fact that the value of the collateral dropped during the preference period below $800,000 to $600,000 and then rose again does not cause any additional preference expense because the increase is not an improvement in the creditor's position as defined by §547(c)(5). Note that this "improvement in position" test that excepts increases in value of collateral from preference avoidance applies only to floating inventory liens.

Two other subsections of §547(c) provide more general limitations on the power of the trustee to avoid preferential transfers. One is §547(c)(2). It provides an exception for transfers (1) made in payment of obligations incurred in the ordinary course of business of the debtor and creditor, (2) made in the ordinary course of business of the debtor and creditor and (3) made on ordinary business terms. Consider this case: DebtorCo is deeply insolvent, just days away from bankruptcy. But it pays all its utility bills for utility service provided the prior month when the bills for those services arrive that day—just as it always does. If DebtorCo pays—even if he pays on schedule—it looks like a payment on an antecedent debt. But if it passes the "ordinary course" test, it is not avoidable. There are slight differences in the way courts articulate the "ordinary course" test, but as a general matter if a payment is made on terms that are (1) consistent with the historical course of dealings between the debtor and creditor, and (2) on terms that are customary in the industry, they are likely to be protected by the ordinary-course defense.

Finally, we need to consider the issue of "transferee knowledge" in preference cases. Consider this example: Debtor-Supermarket owes $100 to Butcher on a demand note. Unknown to Butcher, Debtor-Supermarket also owes $100 to Baker and $100 to Candlestick Maker. Debtor-Supermarket has only $100, with no prospect of getting more. Butcher needs some ready cash; he calls the note and demands payment. Debtor-Supermarket pays Butcher and then, 89 days later, files for bankruptcy. This sounds like an avoidable preference, and the curiosity is this: Nowhere in this sketch do we suggest that the Butcher knew anything about Debtor-Supermarket's financial situation, or that he was trying to nose out other creditors. The point is that the trustee doesn't have to prove such transferee knowledge. It simply is not part of the *prima facie* case. This rule has always been somewhat contentious among bankruptcy professionals—and certainly among trade creditors who get sued simply because the debtor paid a legitimate debt owed to them. Indeed, it was not always thus: Under the old (pre-1978) law, the trustee had to show that the transferee knew that the debtor was insolvent at the time of the transfer.

Next, look at §547(b)(4)(B). It provides a special reach-back rule if the transferee is an "insider." In the "insider" case, the trustee is not bound by the 90-day limit. To undo an otherwise preferential transfer, he can reach back as far as a year.

There is a final note: The overwhelming majority of preference cases are brought under federal law using Code §547. But some states also have preference laws, and the debtor can use those laws too. *See* §544. As a debtor (and, again, when we talk about a "debtor's" avoidance powers throughout, we are using it as shorthand to mean the trustee or DIP) considering a preference action, it is worthwhile having a look at state law; you might find something of use. ■

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