



# Chapter 11:

## A primer on Preference Claims



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A consequence of the global recession is the increase of Chapter 11 filings by United States based companies. For non-US vendors of such Chapter 11 debtors, it is important to understand the key provisions of Chapter 11 to mitigate risks and potential losses. A prominent feature of Chapter 11 cases in the United States is the debtor's ability to recover "preference payments," essentially payments made to vendors 90 days prior to the Chapter 11 filing. For vendors, this is a particularly unpopular aspect of Chapter 11 cases, since the vendor has likely already sustained a write-off of accounts receivable existing at the time of the Chapter 11 filing. After imposing that loss on a vendor, the debtor has two years after the Chapter 11 filing to sue the vendor to recover payments that were made by the debtor in the 90-day period prior to the Chapter 11 filing. As a result of this, vendors must evaluate potential preference exposure to understand the full potential loss arising from a US customer's Chapter 11 filing.

Under Section 547 of the Bankruptcy Code, a preference is a transfer of property of a bankruptcy debtor that (1) was to or for the benefit of a vendor; (2) was on account of an antecedent debt; (3) was made while the debtor was insolvent; (4) was made within 90 days of the filing of the bankruptcy petition; and (5) allowed the vendor to receive more than the vendor would receive in a hypothetical liquidation of the debtor.

A debtor normally issues a written demand for payment on the preference claim prior to commencement of an adversary proceeding. Often debtors offer to discount the claim to receive immediate payment without the need for litigation. If the parties cannot resolve the claim in this manner, the debtor may file an adversary proceeding against the vendor. Vendors are well advised to not pay a preference demand without first performing an analysis of the defences, for claims can often be resolved for a fraction of the demand amount.

If a debtor is able to establish

the criteria set forth above for determining whether a payment is recoverable as a preference, to avoid liability, the vendor must establish one or more of the Bankruptcy Code defences. There are three defences that apply most often, "subsequent new value", "ordinary course of business" and "contemporaneous exchange for new value", all set forth in Section 547 of the Bankruptcy Code.

Subsequent new value occurs when a vendor provides additional goods or services (or the release of a security interest or lien) after the alleged preferential payment to the vendor. This defence acts as a dollar for dollar credit against potential preference exposure. Since subsequent shipments are readily identifiable, this defence is objective and easy to prove.

The ordinary course of business applies if payments were ordinary compared to prior transactions between the vendor and the debtor (paid roughly the same number of days after invoice date and paid in the same manner, such as by check) **or** if the payment was made according to

ordinary business terms in the industry. Changing invoice terms, either formally or informally, may preclude the ordinary course of business defence. Moreover, payments made sooner than usual or before their due date are often considered to not qualify for the ordinary course of business defence. Debtors will generally argue that a payment was not in the “ordinary course of business” if it is more than a few days beyond the due dates of the invoices being paid. However, if the payment history shows that the debtor historically paid the vendor much later than stated invoice terms, then late payments during the preference period would be in the ordinary course of business between the parties. The standard for “ordinary business terms” in the industry has been broadened by court rulings in recent years, so terms are generally considered ordinary if they are not so idiosyncratic as to fall outside the broad range of business practices.

Payments made in response to a vendor’s enforcement of a credit limit can also be considered ordinary course of business. If a customer is operating near its credit limit and wishes to increase its level of orders, but the vendor is not willing to increase the credit line, then by necessity the debtor must pay open invoices sooner than normal. An actual reduction of the credit line is generally fatal to the ordinary course of business defence, but it has been allowed in some cases where the credit line fluctuated frequently in the past.

Another factor that courts have considered in applying the ordinary course of business defence is whether there was any unusual action by the vendor to collect the debt or whether the vendor did anything to gain an advantage in light of the debtor’s deteriorating financial condition. For example, threats of legal action or cutting off sales can be considered undue pressure for payment, although enforcing a consistent credit line is generally not considered undue pressure.

“Ordinary business terms” can sometimes include workout or alternative payment arrangements,

commonly used by financially troubled debtors to gain more time to pay the obligations owed.

Courts have routinely found that where workouts are common in a particular industry, payments made to vendors pursuant to a workout plan are not preferable.

“Contemporaneous exchange for new value” is a defence that arises when the debtor and the vendor intended to exchange payment for new value in the form of goods or services, and the exchange was in fact substantially contemporaneous. The classic example of this defence arises when a customer requests goods or services from the debtor, but the vendor refuses to provide them unless there is first a payment. As this defence hinges on the parties’ intent, there must be evidence that there was an agreement that the payment and the shipment were dependent on one another.

#### Other considerations

- Pre-payments are not preferences since they are not on account of an antecedent debt.
- Payments to a secured creditor are not preferences since the vendor would have been paid in a liquidation in any event.
- Payments to a vendor pursuant to a letter of credit are not preferential since they are not a transfer of the debtor’s property.
- A payment of an account by an entity affiliated to the debtor would similarly not be a transfer of the debtor’s property. However, if the paying entity itself later files bankruptcy, the payments might be recovered as a fraudulent transfer because the entity making the payment may well have received no value in exchange for the payment.
- Vendors facing preference claims usually also hold an unsecured claim against the debtor. The Bankruptcy Code allows a debtor to withhold any dividend on such claim pending payment of the preference. This provides the debtor leverage to negotiate the resolution of the preference claim. In connection with the settlement of a

preference claim, vendors often choose to waive the potential claim dividend as credit to reduce the potential preference exposure.

- Payments made by a debtor to a vendor pursuant to an assumed executory contract are not preferential. Section 365 of the Bankruptcy Code defines an executory contract as any contract where both parties have performance obligations to the other, and would include leases and sales contracts.
- Payment of a vendor’s pre-petition claim as a critical vendor is a “remedy” that allows debtors in Chapter 11 cases to voluntarily pay a vendor’s pre-petition claim since the vendor’s ongoing goods or services are “critical” to the debtor’s survival. As part of a critical vendor agreement, vendors may negotiate a waiver of any preference claims.

If a Chapter 11 debtor pursues a preference claim against a non-US vendor, one possible outcome is the Chapter 11 debtor would obtain a judgment against the “foreign” vendor. If such vendor has no assets in the US, the debtor must then proceed with an extra-territorial enforcement of the judgment, usually through an applicable treaty such as the Hague Convention on the Recognition of an Enforcement of Foreign Judgments. Whether or not a Chapter 11 debtor would actually pursue the judgment in this manner may influence the foreign vendor’s decision on how vigorously to defend the preference claim in the US. For non-US-based vendors with assets in the US, it is likely prudent to defend material preference claims since it is easy for Chapter 11 debtors to transfer judgments with the US’s Federal Judicial System.

Companies that do business with US-based companies need to be aware of the laws relating to preferences, because they can result in a material increase in the potential loss associated with a customer’s Chapter 11 filing.

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