DEALING WITH PREFERENCE DEMANDS AND LITIGATION STRATEGIES

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An account debtor's bankruptcy is never a good thing (usually it means little or no payments on the debt will be forthcoming). Even greater insult to this injury is to receive a demand letter from a chapter 7 Trustee asking that you return funds paid to you by the account debtor in the days or months preceding the bankruptcy filing, which you have undoubtedly already used. This un-Godly process typically begins with the receipt of a letter from the chapter 7 Trustee or his law firm advising that their review of the debtor's books and records indicate an avoidable transfer has taken place and the funds should be returned or litigation will ensue. The demands – or dare I say "shake-downs" – often include a proposal for settlement. Before you whip out your check book and return your "hard earned" – or at least hard fought/sought for - money, you should consult with a bankruptcy attorney to find out (a) if the transaction at issue actually qualifies as a preference transfer, (b) whether and to what extent applicable statutory defenses may be available, and (c) your possible negotiation strategy.

A. What is a Preference?

Preferential transfer law is a creature of Congress as part of the Bankruptcy Code's attempt to level the playing field for all creditors by not allowing one creditor to be favored (receive more) than it would have received if it were to wait in line with all of the other creditors in the debtor's bankruptcy case. Some States have assignment for benefit of creditor statutes that contain similar provisions, but none of these compare the avoiding punch of section 547 of the Bankruptcy Code.

Simply put, a preference is a payment (called a "transfer") of some property (usually cash represented by a check but can also be real or other personal property) of the debtor (important factor – it must be the debtor's property) to a creditor (that is you or your agent), for the purpose of paying a pre-existing debt (called an "antecedent" debt) within 90 days prior to the filing of the bankruptcy case (calculated by not including the filing date and adding backwards), at a time when the debtor was insolvent, and which payment enables you to receive more than you would receive if you had not received the payment and got paid with all of the other creditors in a chapter 7 liquidation. These are the elements of a preference transfer action. The chapter 7 Trustee has the burden to prove these elements. Insolvency is presumed to exist (i.e., you must prove otherwise, which can be expensive). Further, in the context of receiving a check or other payment instrument (which are the most common forms of payment on a debt) the transfer takes place when the instrument is honored by the bank on which it is drawn (i.e., cash the check quickly).

1. The Philosophy of the Preference

Once a bankruptcy case is commenced, preferences are vulnerable to the avoiding powers of a bankruptcy trustee. 11 U.S.C. §§ 544, 547. Section 547 of the Bankruptcy Code provides that a trustee (or a debtor-in-possession) may recover certain payments or transfers that are found to be preferential.[1] "In general, 'a preference' exists when a debtor makes a payment or other transfer to a certain creditor or creditors and not to

[1] Transfers by an insolvent debtor which favor certain creditors over other creditors – so-called preferential transfers – were generally not subject to challenge under common law by the excluded creditors. *See In re Thomas*, 7 B.R. 389, 392 (Bankr. W.D. Va. 1980) ("At common law, this 'favoritism' was legitimate so long as the object of the transfer was to pay or secure payment of an antecedent debt.").

others. Such favoritism is prohibited by 11 U.S.C. § 547(b) when a debtor is in bankruptcy."[2]

At least three purposes of preference avoidance in bankruptcy have been recognized by the courts:

- **To discourage dismembering of the debtor**. *See Jones Truck Lines, Inc. v. Central States S.E. and S.W. Areas Pension Funds (In re Jones Truck Lines, Inc.)*, 130 F.3d 323, 326 (8th Cir. 1997) ("Section 547 is intended to discourage creditors from racing to dismember a debtor sliding into bankruptcy....").
- **To facilitate equality of distribution**. *See Coral Petroleum, Inc. v. Banque Paribas-London*, 797 F.2d 1351, 1355 (5th Cir. 1986), *quoting,* Report of the Committee on the Judiciary, Bankruptcy Law Revision, H.R. Rep. No. 595, 95th Cong., 1st Sess. 373 (1977) ("The preference provisions facilitate the prime bankruptcy policy of equality of distribution among creditors of the debtor.") ("**House Report**"). *See also Lee N. Mortenson v. National Union Fire Insur.*, 249 F.3d 667, 671 (7th Cir. 2001) (holding, "tendency to pay the most pressing creditors when debtor gets into financial difficulties is one of the reasons for the rules against preferences in bankruptcy.").
- **To discourage secret liens**. The preference avoidance powers also help to discourage "secret liens" on the debtor's collateral when those liens remain unperfected until just before the debtor files a bankruptcy petition. In the gap period, other creditors might extend credit on the assumption that the collateral was free and clear. *See Grover v. Gulino (In re Gulino)*, 779 F.2d 546, 549 (9th Cir. 1986). *See also Ray v. Security Mut. Fin. Corp. (In re Arnett)*, 731 F.2d 358, 363 (6th Cir. 1984) ("One of the principal purposes of the Bankruptcy Reform Act is to discourage the creation of 'secret liens'....").[3]

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[2] *Keenan v. Fort Worth Pipe Co. (In re George Rodman, Inc.)*, 792 F.2d 125, 127 (10th Cir. 1986) (citations omitted).

[3] The trustee is blessed under the Bankruptcy Code with an abundance of avoidance vehicles which enable him/her to attack secret liens and other preferential/fraudulent transfers. *See e.g.*, 11 U.S.C. §§ 544(a), 548(a)(1)(A).

2. Section 547

Section 547 of the Bankruptcy Code provides that a trustee (or a debtor-in-possession) may recover certain payments or transfers that are found to be preferential. A trustee or debtor-in-possession may recover a transfer of the debtor's property if the transfer was:

(1) to or for the benefit of the creditor;

(2) for or on account of antecedent debt owed by the debtor before such transfer was made;

(3) was made while the debtor was insolvent;

(4) made on or within 90 days (or 1 year if the creditor is an insider) before the filing of the bankruptcy case; and

(5) enables the creditor to get more by virtue of the transfer than it would if the transfer has not been made and distributions were made under chapter 7 (liquidation).

11 U.S.C. § 547(b).

3. Transfer of an Interest of the Debtor in Property

Initially, the debtor must have an "interest" in the property which was transferred to the judgment creditor. Unfortunately, "property of the debtor is not defined in the preference statute." The term has been found to be synonymous with the definition found in 11 U.S.C. § 541(a) which provides, in part, that "property of the debtor" includes: "all legal and equitable interests of the debtor in property as of the commencement of the case," and it goes on to include "any interest in property that the trustee recovers under section...550 [the property recovery section for sections 547 (preference) and 544 and 548 (fraudulent transfers) actions]," and "any interest in property that the estate acquires

after the commencement of the case." *Cullen Center Bank & Trust v. Hensley (In re Criswell)*, 2 Tex. Bankr. Dec. 18, 21-22 (5th Cir. 1997). If the debtor has no interest in the property at the time it is seized, e.g., pursuant to service of a writ of garnishment and turned over to the judgment creditor, no preferential transfer has occurred. *In re Wilkinson*, 196 B.R. 311, 319-20 (Bankr. E.D. Tex. 1996) ("[I]f wages withheld under a garnishment process are earned within 90 days of the filing of the debtor's petition, the fixing of the execution lien on them may be avoided as preferential."); *Deardorff v. Ford Motor Credit Co. (In re Deardorff)*, 195 B.R. 904, 910 (Bankr. W.D. Wis. 1996) ("[U]ntil the debtor performed the services necessary to earn his wages, he truly had nothing more than the expectation that he would receive them in the future. The debtor had no right to claim those funds until he earned them, and thus could not 'transfer' them until that time.").

4. **To or for the Benefit of the Creditor**

The granting of a consent judgment is clearly for the benefit of the creditor. However judgment entered following a contested proceeding can hardly be said to have been given by the debtor for the benefit of the creditor - i.e., it is granted by the trial court.

5. **For or on Account of an Antecedent Debt**

Antecedent debts are those that pre-date the transfer (payment). A judgment is clearly given - whether by consent or otherwise – for or on account of an antecedent debt (a pre-bankruptcy debt) so this element is not problematic from a judgment creditor's

standpoint. Also, when an account is in arrears and has been placed for collection, the debt is likely antecedent.

6. **While the Debtor was Insolvent**

For purpose of preferential transfer litigation, the Bankruptcy Code presumes the debtor was insolvent in the 90 day period preceding the filing of the case. 11 U.S.C. § 547(f). The creditor should give careful consideration to an insolvency challenge, however, which could easily become very costly. *See, Constructora Maza, Inc. v. Baco de Ponce*, 616 F.2d 573, 577 (1st Cir. 1980)("[A] 'balance sheet' test focuses not on the liquid funds available at the time of transfer, but rather on the liquidation value of the debtor's assets compared to its current liabilities. The determination of the fair valuation of the debtor's assets at a specific time is at best an inexact science, and may often be impossible.").

7. **The Preference Period**

Perhaps the most critical issue in the preference analysis is whether the transfer occurred within 90 days (or one year in the case of an "insider") prior to the filing of the bankruptcy case.[4]

The determination of what constitutes a "transfer" and when it is complete under section 547(b) is a matter of federal law. *Barnhill v. Johnson*, 503 U.S. 393, 397, 112 S.Ct. 1386, 1389, 118 L.Ed.2d 39 (1992). "Transfer" is defined in section 101(54) of the Bankruptcy Code to mean "every mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with property or with an interest in

[4] The term "insider" is defined in section 101(31) of the Bankruptcy Code. 11 U.S.C. §101(31).

property, including retention of title as security interest and foreclosure of the debtor's equity of redemption." 11 U.S.C. §101(54). This definition has been interpreted to include garnishment and similar liens. *In re Conner*, 733 F.2d 1560, 1562 (11th Cir. 1984).

For purposes of preference actions, "transfer" is also defined in section 547(e)(2)(A)-(C) of the Bankruptcy Code. Section 547(b) determines when a transfer is complete. A transfer is complete when it is "perfected." *Conner*, 733 F.2d at 1562. As a general rule, a transfer is perfected either: (a) on the date the transfer takes place between the transferor (judgment debtor) and the transferee (judgment creditor), if the transfer is perfected at or within 30 days after that time; or (b) at the time the transfer is perfected. 11 U.S.C. §547(e)(2)(A)-(C). Otherwise, a transfer will be considered perfected as of the time of the filing of the bankruptcy case. *Id.* The key is perfection.

To determine whether the transfer was perfected, the judgment creditor must look to the type of action undertaken in the collection process - i.e., the action which gave the creditor a superior position as to the property involved. A transfer is effective when a creditor acquires rights in the debtor's property superior to similarly situated creditors. 11 U.S.C. §547(e)(3). Whether a "transfer" was perfected or occurred will depend on state law. *Marsh v. Heldt Lumber Co. (In re McCoy)*, 46 B.R. 9, 11 (Bankr. D. Ariz. 1984) ("The event that triggers perfection under state law would determine when the transfer occurred for bankruptcy purposes.").

8. Defenses to Preference Claims

The only defenses to preference attacks are those provided by statute and they are somewhat specific and limited. A creditor can argue that one or more of the elements of a preference action, set out above, are not met or they can assert one of the affirmative defenses established under the Bankruptcy Code. 11 U.S.C. § 547(c). The statutory affirmative defenses include: (a) the transfer or payment was a contemporaneous exchange for new value; (b) the transfer or payment was made in the ordinary course of business of the debtor and the transferee or made according to ordinary business terms; (c) the transfer or payment creates a purchase money security interest in property acquired by the debtor; (d) the creditor gives new value to the debtor after the transfer was made (only to the extent of the "new value"); and (e) the transfer represents bona fide payments for alimony or child support made in accordance with applicable state or territorial law.[5]

Given the foregoing, it is not difficult to see how payments on a debt can be subject to preference attack.

B. Consent Judgments and Settlements

The granting of a judgment by agreement or consent may not in itself constitute perfection. In this instance, the debtor is merely liquidating a claim. For better or worse, the creditor given an agreed or consent judgment is nothing more than an unsecured creditor because that creditor stands in no better shoes than it did prior to having the judgment - i.e., the judgment saves the creditor the trouble of liquidating the debt but no

[5] As with other avoidance sections of the Bankruptcy Code, a subsequent dismissal of the debtor's case will reinstate any lien avoided under section 547. 11 U.S.C. § 349.

property has been transferred and no payment on the judgment has been made. *Cf., Ebert v. Blackmax Downhole Tools, Inc. (In re Gibraltar Resources, Inc.)*, 197 B.R. 246, 251 (Bankr. N.D. Tex. 1996) (consent judgment in which debtor assigned insurance benefits to creditors constitutes a transfer of the debtor's interest in insurance proceeds as of the date of entry of the judgment - a transfer occurs when the contractual right to payment is assigned, rather than when the payment is actually made).

Further, it is important to note that language in a settlement agreement to the effect that the debtor waives any action to avoid payments or other transfers thereunder as preferential will only be enforceable against the debtor. It may not be enforceable as against a chapter 7 trustee or any other party-in-interest.

C. Judicial Liens

The Bankruptcy Code defines "lien" to mean "a charge against or interest in property to secure payment of a debtor or performance of an obligation." 11 U.S.C. §101(37). "It includes inchoate liens. In general, the concept of lien is divided in to three kinds of liens: judicial liens, security interests, and statutory liens. Those three categories are mutually exclusive and are exhaustive except for certain common law liens." *See* H.R.Rep. No. 95-595, 95th Cong., 1st Sess. 312 (1977), U.S. Code Cong. & Admin. News 1978, pp. 5963, 6269. Section 101(36) of the Bankruptcy Code defines "judicial lien" to mean: "lien obtained by judgment, levy, sequestration, or other legal or equitable process or proceeding." 11 U.S.C. §101(36). Under this definition, when are abstracts of judgment and writs of garnishment, sequestration and attachment transfers for purposes of section 547(b)?

As noted, the existence and effect of a lien is controlled by state law. Therefore, state law must be consulted to determine when the lien is perfected for purposes of whether and when a transfer has occurred. *Phillips v. MBank Waco, N.A. (In re Latham)*, 823 F.2d 108, 110 (5th Cir. 1987). *See also, Chiasson v. First Tennessee Bank, N.A. (In the Matter of Kaufman)*, 187 B.R. 167, 171-72 (Bankr. E.D. La. 1995) (wages withheld within the 90 day preference period, pursuant to a writ of garnishment served prior to the preference period, are avoidable); *In re Jim-O-Lette, Inc.*, 140 B.R. 874, 877 (Bankr. N.D. Tex. 1992) (judgment lien set aside as preferential where recordation was within the 90 day preference period); *In re Veteran Plate Glass Co.*, 71 B.R. 74, 76 (Bankr. N.D. Ohio 1987) (execution lienholder is a judicial lienholder for purposes of bankruptcy and lien interest by seizure constitutes a "transfer of an interest of the debtor in property" for purposes of the preference provision).

In Texas, judicial liens are perfected when the judgment is recorded - abstracted - in the county where real property is located. *Rosenfield*, 62 B.R. at 522. With respect to garnishments, sequestrations, and attachments (executions), which are the equivalent of seizing property of the debtor by virtue of legal process, because the property is often in the hands of a third-party (usually a garnishee bank), the mere issuance of the writ does not accomplish perfection. The writ must be served to constitute perfection. *Id.* 62 B.R. at 522 ("transfer" occurs when the writ of garnishment is served because this is the date the garnishment is perfected, "despite payment having been made during the ninety-day period," and the judgment creditor's status is changed from unsecured to secured). *See also, In re Latham*, 823 F.2d at 110; *Weaver v. Aquila Energy Marketing Corp.*, 196

B.R. 945, 95-52 (S.D. Tex. 1996); *cf., Freedom Group, Inc. v. Lapham-Hickey Steel Corp. (In re Freedom Group, Inc.)*, 50 F.3d 408, 412 (7th Cir. 1995) (discussing garnishment does not transfer money or other property until final order of garnishment is issued). Further, the writ or attachment only applies to property subject to the writ and, in the context of garnishments, it has been held that the lien will attach only to identifiable, specific assets owned by the debtor. *Westex Foods, Inc. v. FDIC (In re Westex Foods, Inc.)*, 950 F.2d 1187, 1191 (5th Cir. 1992); *Phillips*, 823 F.2d at 110 (garnishment of garnishment debtor's trust held by bank).

D. Effect of a Preferential Transfer

The key to bankruptcy is equality of distribution among similarly situated classes of creditors. A properly perfected judicial lien, particularly one which enables the creditor to seize assets ahead of other creditors or enhance its status vis-a-vis other creditors (i.e., change from unsecured to secured status) permits the judgment creditor, by virtue of the transfer, to receive more than that creditor would receive if the transfer had not occurred and the creditor were to receive a distribution in the estate under a chapter 7 liquidation. *Weaver*, 196 B.R. at 954 (change from unsecured to secured is a "transfer" and the change in status "allows [the judgment creditor] to recover a greater percentage of its claim").

Typically, the impact analysis may be accomplished by an examination of the debtor's schedules to determine what unsecured creditors would receive on liquidation and comparing that with what the judgment creditor received by virtue of the preferential transfer. In *Weaver*, the court applied the "benefit to the estate" test found in 11 U.S.C. §

550(a), as the trustee was attempting to avoid a security interest acquired by the garnishment lien, but found that the section 550(a) test was met because of the existence of a benefit under the confirmed liquidation plan and allowed the trustee to avoid the transfer.

E. Litigation Strategies and Practice Tips

There are a number of strategies that can be implemented in advance of and in the face of a preference demand or lawsuit.

1. Responding to the Preference Demand Letter

First, remain calm. It is just a letter. A stronger reaction might be justified if you were served with an actual lawsuit. Second, resist the temptation to throw the demand letter in your "circular file" (i.e., your trash can). Ignoring a demand letter may only serve to embolden the Trustee and eliminate a later opportunity to resolve the matter. As noted above, you may have certain valuable, sustainable defenses that you want to flesh out and/or as to which you require additional information. Often the source of the Trustee's information, which led to the issuance of the demand, is incorrect and/or based on limited data. An initial response may be necessary to gather information to establish whether the Trustee can prove the elements of a preference and/or to support a defense. This also will provide a breathing period to get your arms around what is happening and whether you will be able to mount a good defense and/or enable you to begin the settlement negotiation process. Further, most demands contain relatively small discounts for up-front payments, so unless the offer is just "too good to refuse" you are better off

delaying the process while you evaluate the Trustee's evidence and applicable defenses. Bottom line: you want to respond verbally or in writing to all demands.

2. Venue

The *situs* of preference litigation is limited to the district in which the defendant resides for proceedings to recover money or property from a non-insider of less than $11,725 (for adversary proceedings brought before April 1, 2010 the venue limit was $10,950).

3. Monetary Thresholds

An individual debtor whose debts are primarily consumer debts is not responsible for a preference if the aggregate value of all property that constitutes or is affected by such transfer is less than $600. 11 U.S.C. § 547(b)(8)). *See In re Hailes*, 77 F.3d 873, 874-75 (5th Cir. 1996) (finding section 547(c)(8) requires aggregation).

Further, a debtor whose debts are not primarily consumer debts is not responsible for a preference when the aggregate value of all property that constitutes or is affected by such transfer is less than $5,000. 11 U.S.C. § 547(b)(9).

4. Jury Trial

In limited circumstances jury trials are permitted in bankruptcy court. 28 U.S.C. § 157(e). If the creditor believes it has exposure to preferential transfer avoidance, it may want to consider using the threat of a jury trial of the avoidance action to provide leverage in settlement negotiations. Participating in bankruptcy can constitute a waiver of the right to jury trial. If the amount of the preference is great but the potential claim against the estate is small or the potential distribution from the estate will be nominal,

you may want to consider not filing a proof of claim.

5. Proof of Claim

If a preference transfer is avoided, by agreement or otherwise, the creditor has the right to file a proof of claim as to the amount of the avoided claim, even if the time for filing claims has expired. 11 U.S.C. § 502(h). Typically, chapter 7 Trustees will demand waiver of a claim against the estate as part of any settlement. Consider a larger settlement payment if the potential of a distribution on a claim will be greater.

6. Information Needed to Determine Defenses

Your company or client will likely be the source of information to enable formulation of a response to a preference demand letter. Before contacting counsel, you may want to gather the payment history involving the debtor for at least the year preceding the bankruptcy filing. This information typically will include:

- Copies of all correspondence, contracts, credit applications, telephone logs, emails, and the like involving the debtor;
- A copy of all invoices, showing invoice date, terms and amount of each invoice;
- A copy of all payments received from the debtor identifying the method of payment (EFT, check, cashier's check, money order, cash) and the date the payment was posted to your bank account;
- The number of days elapsed between date of invoice and date of payment was received; and

- All persons involved with the debtor's account, so they can advise as the business terms between the parties and how payments were made, applied and any unique issues involving the debtor.

This information will prove valuable to your counsel in assessing your risk and exposure to avoidance of alleged preference payments.

7. <u>An Attorney May Not Be Required But Needed</u>

While it may not be very appealing to hire an attorney to help you get through this process, kind of like adding salt to the wound, the reality is that there are risks going it alone and having an attorney represent you can actually save time and money, particularly if a settlement is in prospect. In bankruptcy, like many other areas of the law, it really does help to walk-the-walk and talk-the-talk. Also, most attorneys will set fee rates based on amounts in dispute and will be willing to work with you on terms of engagement given the particular circumstances involved.

8. <u>Attorneys' Fees Are Not Generally Recoverable</u>

If successful, a trustee is not ordinarily entitled to recover attorney's fees in prosecuting a preference action (they will be paid from the "estate"), but interest will continue to accrue on the amounts at issue. Also, you will not be able to recover fees and expenses paid to your attorney in defending against a preference demand or lawsuit. The factors, together with the amount in controversy, should be considered with developing a settlement strategy.

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