

# Defending Against Preference Avoidance Actions

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A preference action under Bankruptcy Code Section 547 permits a trustee (or a debtor-in-possession) to avoid and recover certain payments made by the debtor to a creditor within 90 days of filing of the bankruptcy petition if certain conditions are met. The 90 day look-back period is extended to one year if the creditor is an insider at the time of the transfer. A creditor sued to recover a preference payment may have several defenses to the preference action. The first defense under Bankruptcy Code Section 547(c)(1) involves challenging the existence of one or more of the elements of a preference. The trustee has the burden of proving each element of a preference action to satisfactorily state a claim to avoid and recover a pre-petition payment as a preference. Pursuant to Bankruptcy Code Section 547(b), any transfer of an interest of the debtor in property may be avoided as a preferential transfer if it was (1) to or for the benefit of a creditor; (2) for or on account of an antecedent debt owed by the debtor before such transfer was made; (3) made while the debtor was insolvent; (4) made -- (a) on or within 90 days before the date of the filing of the petition; or (b) between 90 days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider; and (5) that enables such creditor to receive more than such creditor would receive under chapter 7 of the Bankruptcy Code if the transfer had not been made. The trustee has the burden of proving each element by a preponderance of the evidence. The trustee's failure to prove each element of a preference action precludes a finding that a transfer was preferential. In addition to attacking the sufficiency of the elements of the preference claim, Bankruptcy Code Section 547(c) provides a number of affirmative defenses a creditor can assert to challenge a preference action. Among the defenses available to creditors are the following statutory defenses: (1) ordinary course of business or financial affairs defense; (2) contemporary exchange for new value defense; and (3) new value defense. The creditor has the burden of proving any defense asserted to a preference action. The ordinary course defense provides that a transfer cannot be avoided (1) to the extent that such transfer was in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee, and such transfer was made; (2) in the ordinary course of business or financial affairs of the debtor or the transferee; or (3) made according to ordinary business terms. To determine whether the ordinary course of business defense is available to the creditor, you must examine the parties' prior dealings and compare them with the parties dealing with respect to the subject transfer(s). If a transfer made

during the preference period was made on terms similar to the parties dealing before the preference period, the ordinary course defense may be available as a challenge to the preference action. For example, if a payment is made 30 days after invoice during the preference period, and a review of past payments between the parties shows that payments were generally made within 30 days after the invoice, the payment during the preference falls within the ordinary course defense. Even if the parties had no prior dealings, a transfer still may have been made in the ordinary course of business if certain indicia are present. While the specific indicia that courts will consider depend on the specific jurisdiction, courts may consider (1) whether the transaction is out of the ordinary for a party in the debtor's position; (2) whether the debtor complied with the terms of the parties' contractual arrangement; (3) the general conduct of the parties; and (4) the parties' ordinary course of dealing in other similar business transactions. Another challenge to a preference action is a "contemporaneous exchange" defense, which provides that a transfer may not be avoided to the extent that such transfer was (1) intended by the debtor and the transferee to be a contemporaneous exchange for new value given to the debtor, and (2) in fact a substantially contemporaneous exchange. For a transaction to fall within the contemporaneous exchange defense, the debtor's payment to the creditor must have been made at or near the time that the product or service was provided to the debtor. Different courts have different approaches as to what constitutes a contemporaneous exchange, but generally the payment may not be more than 10 days after the creditor provided the goods or services. A transaction, however, need not only be contemporaneous, but it must create new value as well. The question of new value is always a question of fact, its form can be virtually anything. Thus, to prevail on a "contemporaneous exchange for value" defense, the court must find that the exchange was intended to be substantially contemporaneous and that new value was given in exchange for the preferential treatment. The intent of the parties constitutes the most critical element. The purpose of this defense is to protect creditors in transactions that do not diminish the bankruptcy estate. Finally, the simplest of the statutory defenses to a preference action is the "new value" defense. A trustee may not avoid a transfer to a creditor "to the extent that, after such transfer, such creditor gave new value to or for the benefit of the debtor - (1) not secured by an otherwise unavoidable security interest, and (2) on account of which new value the debtor did not make an otherwise unavoidable transfer to or for the benefit of such creditor." A creditor provides the debtor with "new value" when, after receiving a preferential transfer, the creditor provides additional goods or services. The "new value" of the goods and services is credited as a reduction of the prior preference payment on a dollar for dollar basis. While ordinary course, contemporaneous exchange, and new value defenses are the most common defenses to a preference action, a creditor may have additional defenses to a preference action. For example, corporate debtors cannot avoid transfers of less than \$5,000. Additionally, if the creditor is a fully secured creditor at the time the transfers were made, then the trustee cannot avoid the payments as a preferential transfer. However, the granting of a security interest by the debtor during the preference period may itself be an avoidable transfer. All of these defenses are fact sensitive, have become increasingly complex, and should be handled by competent bankruptcy counsel.

# Related Practices

## Creditors' Rights and Bankruptcy

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