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BAPCPA: ONE YEAR LATER

BAPCPA Introduced a Whole New World for Preferences

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The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) significantly changed preference law, swinging the pendulum of power more in the direction of creditors. Yet preferences remain one of the most misunderstood — and emotionally charged — elements of bankruptcy law. Credit managers, financial and senior management, and even some attorneys may find this area of the law confusing.

A fundamental goal of bankruptcy law is equal treatment of similarly situated creditors. To accomplish this goal, the U.S. Bankruptcy Code allows a debtor to avoid and recover payments it made to creditors within 90 days prior to the debtor's bankruptcy filing, subject to certain potential defenses. The concept behind the preference rule is that creditors who exert collection pressure on a debtor during this period are disproportionately more likely to be paid before the filing, to the detriment of other creditors. Hence, the preference claw back allows a debtor or trustee to avoid and recover money paid within 90 days prior to the bankruptcy filing for equitable redistribution to all unsecured creditors.

From a credit manager's perspective, this may appear to be incredibly unfair. First, the entire accounts receivable balance is placed in jeopardy, and the company may be required to refund money to the debtor (or trustee) for alleged preferential payments. Second, the credit manager is penalized for being proactive and doing a good job of reducing his accounts receivable exposure on a financially unstable customer prior to its bankruptcy filing. Finally, it may appear to the credit manager that the ultimate beneficiaries of the claw back of preferences are not the general unsecured creditors, but rather the trustees, plan administrators, and professionals who seem to consume most or all of the preference recovery.

Three significant changes relative to preferences, all of them creditor friendly modifications, were introduced through BAPCPA:

1. Adjustments to the "ordinary course of business" defense now require only that a creditor prove that payments were ordinary between the creditor and the debtor or ordinary within the industry. Before BAPCPA went into effect, a creditor had to prove both of those elements, which imposed a relatively difficult and costly burden.
2. Preference action lawsuits can no longer be filed for claims of less than $5,000.
3. Preference action lawsuits for amounts less than $10,000 now must be litigated in a defendant's court of residence rather than in the debtor's bankruptcy court venue.

In essence, these three changes improve a preference defendant's position in litigation and theoretically should substantially eliminate the large quantity of relatively small dollar preference lawsuits that had become increasingly commonplace.

Preference Defenses

When a customer files for Chapter 11 protection, a credit manager usually:

1. Places a hold on all shipments.
2. Notifies the sales department.
3. Explores shipping to the debtor post-petition on credit terms requiring cash on delivery or cash in advance of delivery.
4. Adjusts the bad debt reserve or writes off some or all of the debt.
5. Files a proof of claim.

At that point, unless the credit manager serves on the Official Committee of Unsecured Creditors, the person moves on to other problems until the pre-litigation preference demand letter arrives — usually months or even years after the bankruptcy filing.

As a defensive measure against the arrival of the preference demand letter, a credit manager should summarize all payments received within the 90 days prior to the filing, using the date the check was deposited, and all new shipments after the date of the oldest payment in the 90-day period. The credit manager must match and trend both payments and shipments to do this accurately. The data allows the manager to analyze the simplest preference defense, which is "new value." Simply put, the new value defense allows a defendant to deduct from the preference payment liability the value of any new goods or services the defendant provided to the debtor. New value can be demonstrated quickly and may substantially reduce or eliminate many preference claims altogether.

The pre-litigation demand letter provides two important facts: how much the trustee believes the gross preference is, which may be more or less than the creditor's records indicate, and some indication of the proposed settlement range (e.g., 70 percent, 75 percent, 80 percent, etc.).

By preparing a preference file at the time a debtor files bankruptcy, a creditor will know where it stands regarding the new value defense, which may settle the issue immediately. The creditor should call the debtor's contact person to discuss the claim. It is critical to respond to a preference demand letter in

continued on page 2

continued from page 1

a timely manner. Ignoring the letter or procrastinating in responding to it almost certainly will result in costly litigation. In discussing the preference claim with the debtor's contact person, a creditor can point out discrepancies in records and ascertain its maximum preference liability after deducting for new value. This exercise can be done in-house or by employing outside counsel.

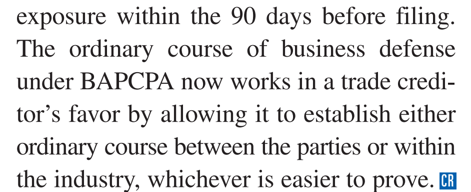
The next step in the process is somewhat more technical because it involves the ordinary course of business defense. BAPCPA gives a creditor, as a defendant, two options to define ordinary course of business: between the parties or in the creditor's industry. In other words, a creditor may analyze the payment cycle during the 90-day preference window (min-max-mean) against prior history, such as the last 12 months, or based on industry statistics, which usually are available from industry associations.

Because the ordinary course defense requires a more technical analysis that is likely to require expertise in preference law, a creditor should consider hiring an attorney, another expert, or both to handle the work. Therefore, creditors should make sure they have a large enough "net preference" amount after applying new value to make spending the money worthwhile. Any net preference of less than $25,000 should be settled to avoid these costs and others associated with potential litigation on the issue. However, if a creditor decides to analyze its position regarding an ordinary course defense, changes in the law brought about by BAPCPA give it the ability to choose the most advantageous definition of ordinary course of business.

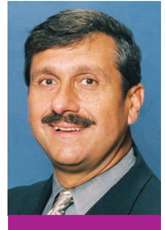
Restoring Balance

BAPCPA has helped restore some balance to what had become excessive preference litigation of dubious benefit to a debtor's estate. Basic preference analysis and settlement negotiations can be done by credit managers, attorneys, or financial advisors. Preference lawsuits involving amounts less than $10,000, which essentially had become acts of extortion because the cost to creditors of defending against them usually exceeded the potential preference claim, are now believed to be dead.

New value as a defense is relatively simple to analyze and can be a very effective means for reducing large preference claims. The process approximates by how much a trade creditor has improved its accounts receivable



exposure within the 90 days before filing. The ordinary course of business defense under BAPCPA now works in a trade creditor's favor by allowing it to establish either ordinary course between the parties or within the industry, whichever is easier to prove. CR



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