

THE NEW WORLD OF PREFERENCES

by Bob Troisio, Managing Director, and Dan Dooley, Principal

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) dictated some very important changes on preference claims that swung the pendulum of law more in the direction of the creditors.

BAPCPA includes three significant changes relative to preferences, all of them creditor-friendly:

1. The “Ordinary Course of Business” defense now requires a creditor to prove only that payments were ordinary either between the creditor and the debtor or within the industry. Previously, creditors had to prove both, which was fairly difficult and expensive.
2. Preference action lawsuits can no longer be filed for claims of less than \$5,000, although preference demand letters can still be sent for those small preference amounts.
3. Preference action lawsuits of less than \$10,000 against businesses (non-consumers) must now be litigated in the defendant’s court of residence vs. the debtor’s bankruptcy court, which was previously the case.

In essence, these three changes improve a preference defendant’s position in litigation. They should also substantially eliminate the large number of relatively small-dollar preference lawsuits that have become commonplace in the last few years.

Equal treatment?

A fundamental concept of bankruptcy is that creditors in similar situations should be treated the same. At the same time, the law recognizes that creditors who put collection pressure on a debtor are more likely to be paid disproportionately well before a bankruptcy filing, to the detriment of other creditors.

The Bankruptcy Code includes a preference claw-back provision that allows debtors to recover payments made to general unsecured creditors within 90 days prior to the bankruptcy filing — thereby recovering inequitably paid money for distribution to all unsecured creditors.

From a credit manager’s perspective, this appears incredibly unfair. First, the entire accounts receivable balance is in jeopardy and now the company may be required to refund money to the debtor for

alleged preferential payments. Second, the credit manager is penalized for doing a good job, i.e., reducing A/R exposure on a financially unstable customer. Finally, it appears — at least to the credit manager — that the ultimate beneficiaries of the claw back are the trustee, plan administrators and professionals who seem to consume most or all of the preference recovery.

So, when a customer files for Chapter 11 protection, what does a credit manager do?

1. Places a hold on all shipments
2. Notifies the sales department
3. Explores shipping the debtor post-petition on credit terms, COD or CIA
4. Adjusts the bad debt reserve or writes off some or all of the debt
5. Files Proof of Claim

At that point, it’s on to other problems until the pre-litigation preference demand arrives — months or even years after the filing.

As a defensive measure, however, we recommend that the credit manager summarize all payments within 90 days prior to the filing (use the date the check was deposited) and all new shipments after the date of the oldest payment in the 90-day period. Matching and trending both payments and shipments permits analysis for the simplest preference defense — New Value. We find that New Value can be quickly demonstrated and can substantially reduce or eliminate many preference claims.

When the pre-litigation demand letter arrives, it provides two important facts: How much the trustee believes the gross preference to be and the initial proposed settlement range. If you prepared the preference file at the time of filing, you will immediately know where you stand on New Value — which may immediately settle the issue.

Timely discussion

Call the contact person and discuss the claim, identifying discrepancies in records and your maximum preference liability after New Value. This can be done inexpensively in-house or by employing counsel. A timely response is critical, however, because ignoring the letter or procrastinating will almost certainly result in costly litigation.

The next step — the Ordinary Course defense — is a little more technical. The BAPCPA allows you to use either ordinary course as between the parties or ordinary course in your industry. Simply put, you must analyze the payment cycle during the 90-day preference window (min-max-mean) against prior history (say the last 12 months) or based upon industry statistics (available from industry associations). Since this requires a strong knowledge of preferences, you will probably need to hire an attorney, an expert or both at this point.

We advise clients to be sure they have big enough “net preference” amounts after applying New Value to make spending the money worthwhile. We believe any net preference of less than \$25,000 should be settled.

Balanced playing field

BAPCPA has helped restore some balance to preference litigation. A New Value defense is simple to analyze and very effective in knocking down large gross preference claims to more reasonable amounts that approximate how creditors have improved their accounts receivable exposure within the 90 days before filing.

The Ordinary Course defense now allows creditors to select the most advantageous option, be it ordinary course between the parties or within the industry. Additionally, preference lawsuits for less than \$10,000, for which the cost of defense usually exceeded the potential preference claim, are now believed to be dead.

Lastly, basic preference analysis and settlement negotiations can be done by credit managers, attorneys and/or financial advisers. With due deference to our many attorney friends, their involvement is more cost effective for big-dollar preference amounts and more complicated situations.

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