SPECIAL REPORT

WHAT DO YOU MEAN I HAVE TO GIVE THAT MONEY BACK?

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This Special Report was written by Daniel P. Hale, J.D., CPCU, ARM, CRM, LIC, AIC, AIS, API of Marsh & McLennan Agency LLC. Mr. Dan Hale can be contacted at 734-525-2429 or dhale@mma-mi.com. More Special Reports are available at www.mma-mi.com.

Business bankruptcy filings are at an all-time high. Between March of 2007 and March of 2008, there were 846 businesses that filed for bankruptcy in the Federal Bankruptcy Court for the Eastern District of Michigan. That works out to an average of almost three new filings per day and makes up 23% of all business bankruptcies in the states of Kentucky, Michigan, Ohio, and Tennessee combined. Even worse, filings are expected to increase to more than 1,200 for the 2008-2009 year.

With such a high rate of business failure, many businesses have begun receiving “preference” letters directing the return of money received from bankrupt debtors. Under the Bankruptcy Code, the federal government has the authority to reclaim any payments made by the bankrupt entity within 90 days of the bankruptcy filing.

For example, assume that your company is in the business of painting automotive parts. You receive a preference demand from the bankruptcy trustee of a bankrupt automotive supplier with which your company did business. The bankruptcy trustee has demanded that your company repay more than $130,000 in payments from the bankrupt supplier for services provided. However, it turns out that the bankrupt supplier still owes your company more than $100,000. Unless you are able to establish one of the statutory defenses, the bankruptcy court will enforce its order for the $130,000.

The purpose of this Special Report is to review the risk of loss associated with a preferred payment action and discuss some of the defenses that are available.

I. Preferred Payment Actions

In the technical sense, preferences are payments or other transfers made within 90 days prior to a bankruptcy filing that are on account of antecedent or pre-existing debt, which was made at a time when the debtor was insolvent, and would allow the transferee (the preference defendant) to be "preferred" by recovering more than it would have had the transfer not been made and the defendant instead had simply filed a proof of claim for the amount involved.

For insiders such as officers, directors, and affiliates, the reachback period is extended to a full year prior to the bankruptcy petition.

When Congress enacted the Bankruptcy Code, the policy behind preferences was to level the playing field for all creditors by not allowing a creditor to receive more than it would have within the debtor's bankruptcy case.

The details of the U.S. Bankruptcy Code involving preferences are as follows:

11 U.S.C. Section 547 – Preferences

* * *

(b) Except as provided in subsection (c) of this section, the trustee may avoid any transfer of an interest of the debtor in property—
  (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 ninety 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 if—
    (A) the case were a case under chapter 7 of this title;
    (B) the transfer had not been made; and
    (C) such creditor received payment of such debt to the extent provided by the provisions of this title.

* * *

Note that payments to a fully secured creditor are not preferences because the creditor would not get more than he would have in bankruptcy, where the creditor would get the value of the collateral.

II. Defenses to Preference Actions

Although the Bankruptcy Code gives the Court the power to recover these transfers, your business may have certain defenses to eliminate, or at least lessen, your exposure.

These defenses include payments made within the ordinary course of business; contemporaneous exchange for new value; payments made outside of the 90 day preference period; settlements during the bankruptcy case; and/or payments made via C.O.D.

The "ordinary course of business defense," was designed to protect parties who engage in normal transactions with a financially troubled business. This defense is one of the most common defenses available to preference recipients. In order to qualify for this defense, the payee must establish three main elements.

Ordinary Course of Business Defense

- The debt was incurred in the ordinary course of business.
- The payment was made in the ordinary course of business.
- The payment was made according to ordinary business terms.

§547(c) of the Bankruptcy Code governs defenses to preference payment actions. The statute provides in relevant part, as follows:

(c) The trustee may not avoid under this section a transfer—
  (1) to the extent that such transfer was—
    (A) intended by the debtor and the creditor to or for whose benefit such transfer was made to be a contemporaneous exchange for new value given to the debtor; and
    (B) in fact a substantially contemporaneous exchange;
  (2) to the extent that such transfer was—
    (A) ***in payment of a debt incurred by the debtor in the ordinary***

<u>course of business</u> or financial affairs of the debtor and the transferee;

(B) ***made in the ordinary course of business*** or financial affairs of the debtor and the transferee; and

(C) ***made according to ordinary business terms***;

(3) that <u>creates a security interest in property</u> acquired by the debtor--

(A) to the extent such security interest secures new value that was—

(i) given at or after the signing of a security agreement that contains a description of such property as collateral;

(ii) given by or on behalf of the secured party under such agreement;

(iii) given to enable the debtor to acquire such property; and

(iv) in fact used by the debtor to acquire such property; and

(B) that is perfected on or before 20 days after the debtor receives possession of such property;

(4) to or for the benefit of a creditor, to the extent that, after such transfer, such <u>creditor gave new value to or for the benefit of the debtor</u>—

(A) not secured by an otherwise unavoidable security interest; and

(B) on account of which new value the debtor did not make an otherwise unavoidable transfer to or for the benefit of such creditor;

(5) that creates a <u>perfected security interest in inventory or a receivable or the proceeds of either</u>, except to the extent that the aggregate of all such transfers to the transferee caused a reduction, as of the date of the filing of the petition and to the prejudice of other creditors holding unsecured claims, of any amount by which the debt secured by such security interest exceeded the value of all security interests for such debt on the later of—

(A)

(i) with respect to a transfer to which subsection (b)(4)(A) of this section applies, 90 days before the date of the filing of the petition; or

(ii) with respect to a transfer to which subsection (b)(4)(B) of this section applies, one year before the date of the filing of the petition; or

(B) the date on which new value was first given under the security agreement creating such security interest;

* * *

(7) to the extent such transfer was a bona fide payment of a debt to a spouse, former spouse, or child of the debtor, for alimony to, maintenance for, or support of such spouse or child, in connection with a separation agreement, divorce decree or other order of a court of record, determination made in accordance with State or territorial law by a governmental unit, or property settlement agreement, but not to the extent that such debt—
   (A) is assigned to another entity, voluntarily, by operation of law, or otherwise; or
   (B) includes a liability designated as alimony, maintenance, or support, unless such liability is actually in the nature of alimony, maintenance or support; or

(8) if, in a case filed by an individual debtor whose debts are primarily consumer debts, the aggregate value of all property that constitutes or is affected by such transfer is less than $600.

* * *

In most cases, parties have a series of contracts or purchase orders, as well as a payment history, that give context to the ordinary course of business between them. This begs the question of whether a debt can be considered as having been incurred in the ordinary course of business of the debtor when there have been no other past transactions to which the transaction can be compared.

In this case, courts look to past practices with other similar parties. Courts have allowed a preference defendant to assert the ordinary course of business defense involving a debt created by the first contract or transaction between the parties; however, the Ninth Circuit articulated a special rule when a "first time" debt is involved:

> "When we have no past debt between the parties with which to compare the challenged one, the instant debt should be compared to the debt agreements into which we would expect the debtor and creditor to enter as part of their ordinary business operations. This analysis should be as specific to the actual parties as possible. Thus, we hold that to fulfill § 547(c)(2)(A), a first-time debt must be ordinary in relation to this debtor's and this creditor's past practices when dealing with other, similarly situated parties. Only if a party has never engaged in similar transactions would we consider more generally whether the debt is similar to what we would expect of similarly situated parties, where the debtor is not sliding into bankruptcy."

The trend today seems to be for trustees or debtors in possession to sue everyone who received payment of any sort during the 90 days before filing and to sort out the merits of the plaintiff's claims later.

III. Insider Preferences

The bankruptcy code also permits the recovery of payments on old claims owed to insiders, such as relatives, corporate officers or directors, or related entities. For insiders, the trustee can look back to payments made within a year of the bankruptcy filing. This provision attempts to prevent the debtor from paying relatives and business decision makers at the expense of the trade creditors.

IV. Conclusion

Business should remain aware of their exposure to financial loss arising out of preference actions involving their financially-troubled customers.

With these things in mind, we encourage all clients to maintain a watchful eye over their accounts receivable and stay informed of their customers' financial condition.

If your business is predisposed to preference actions, we encourage you to contact us so that we can put you in touch with a business attorney who can further advise you on strategies to reducing or eliminating your exposure to this type of loss.

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