ONCE BITTEN, TWICE SHY

RESTRUCTURING PAYMENT OF PAST DUE ACCOUNTS TO AVOID BANKRUPTCY PREFERENCE LIABILITY

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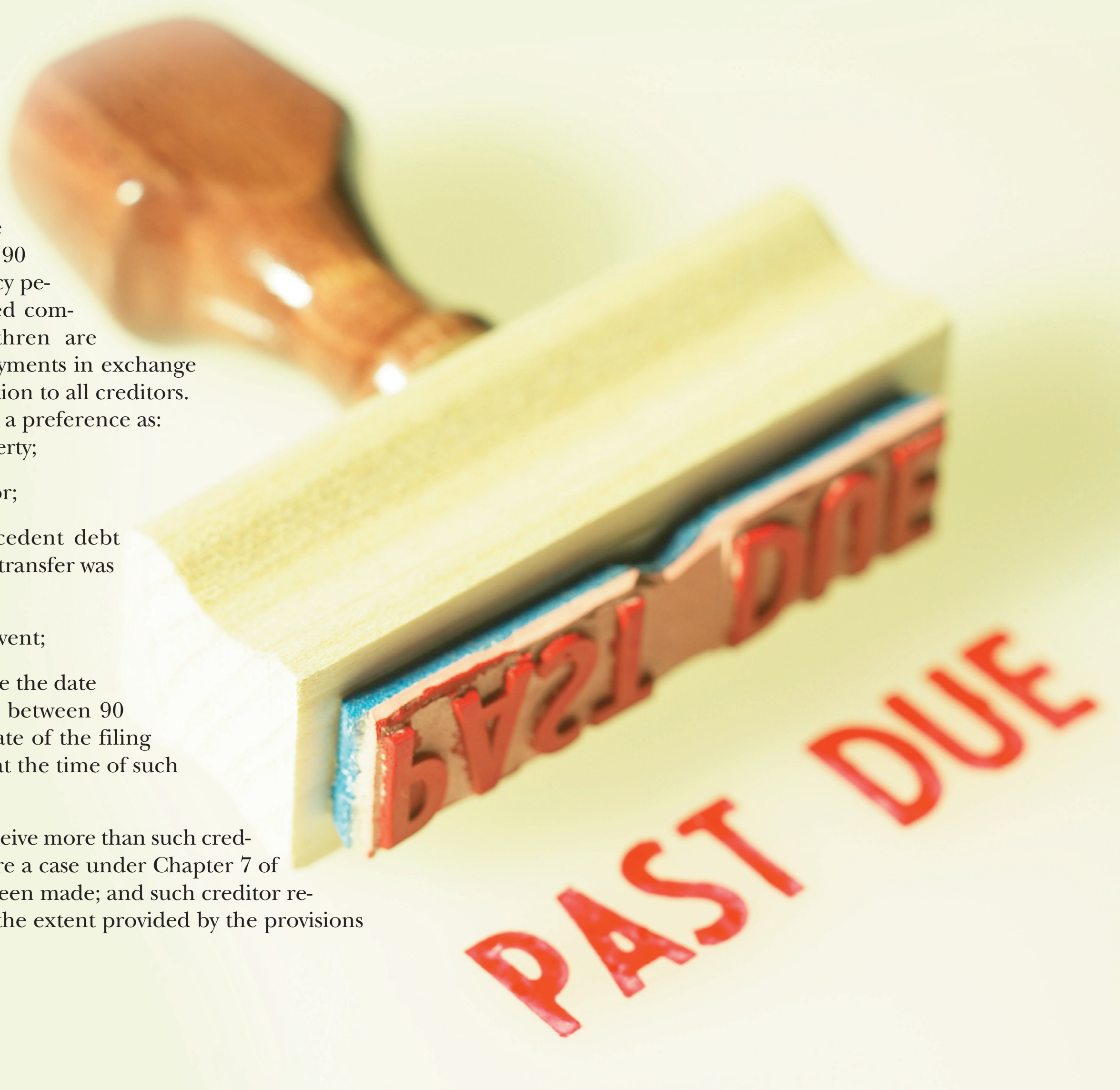
"Let me get this straight: They filed bankruptcy owing us $250,000, and now they're suing to recover the pittance they paid us just before they filed? Are you serious?!?!?" If you've ever found yourself yelling similar words to your attorney, or if you're the attorney who held the phone at arm's length until your client calmed down, then you probably wondered what could be done differently next time to avoid costly preference litigation. Given the rising number of bankruptcy filings since the "Great Recession" began and the attendant risk of preference claims, it's more important than ever to understand the effect that a debt restructuring agreement with a potential debtor may have on preference exposure.



PREFERENCES IN A NUTSHELL

In an effort to achieve equality of treatment among similarly situated creditors, Section 547 of the Bankruptcy Code gives the debtor or trustee authority to avoid transfers or payments made by the debtor to a creditor within 90 days before the debtor's bankruptcy petition date. Creditors who received comparatively more than their brethren are forced to disgorge pre-petition payments in exchange for a *pro rata* post-petition distribution to all creditors.

The Bankruptcy Code defines a preference as:

- Any transfer of the debtor's property;
- To or for the benefit of a creditor;
- For or on account of an antecedent debt owed by the debtor before such transfer was made;
- Made while the debtor was insolvent;
- Made on or within 90 days before the date of the filing of the petition; or 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;
- That enables such creditor to receive more than such creditor would receive if the case were a case under Chapter 7 of the Code; the transfer had not been made; and such creditor received payment of such debt to the extent provided by the provisions of Title II of the code.

A typical preference is a payment made by an insolvent debtor to an unsecured creditor within the ninety-day preference period. The debtor or trustee ordinarily has two years after the petition date within which to file the preference "adversary proceeding" in bankruptcy court. In theory, the risk of preference liability discourages creditors from using aggressive collection tactics that might push their debtor into bankruptcy.

One of the most common statutory affirmative defenses to a preference action is the "ordinary course of business" defense. To succeed, the defending creditor must prove that:

- the debt was incurred in the ordinary course of business or financial affairs between the creditor and the debtor, and
- the payments were made to the creditor in the ordinary course of business or financial affairs between the creditor and the debtor ("subjective test") or the payments were made according to ordinary business terms ("objective test").

The ordinary course of business defense is intended to protect recurring, customary trade transactions, not payments in settlement of contractual claims. The defense essentially pardons those creditors who work with a potential debtor in a way that helps the debtor avoid the slide into bankruptcy.

THE CREDITOR'S DILEMMA

Imagine that a customer is in financial distress and has fallen behind on payments due to a creditor, but the customer is not ready to enter bankruptcy. The creditor may be willing to continue providing goods or services to the customer on credit terms, but only if the customer enters an agreement to pay the past due balance in full or in part. The agreement will provide the customer with a longer term for repayment than originally contracted and induce the creditor to forbear a collection action. The customer may be asked to sign a promissory note payable to the creditor in the amount of the past due balance, and the creditor may insist on receiving a lien or guarantee to secure payment.

The question that arises in this situation is whether any of the payments made under the debt restructuring agreement could fall within the ordinary course of business defense and be insulated from preference recovery if the customer subsequently enters bankruptcy. In other words, is it worth the creditor's effort to pursue and implement a debt restructuring agreement?

MAKING THE BEST OF A BAD SITUATION

While preference plaintiffs often argue that payments made on past due debt pursuant to a debt restructuring agreement are *per se* outside of the ordinary course of business, many courts have disagreed. The decisions tend to be fact-specific, and the applicability of the defense tends to turn on whether the terms of the debt restructuring agreement are ordinary when compared to the ways that other participants in the debtor's and creditor's industry have dealt with financial distress. The burden of proving whether the terms are "ordinary" rests with the creditor. For example, the Second Circuit remarked that "[i]t is not difficult to imagine circumstances where frequent debt rescheduling is ordinary and usual practice within an industry, and creditors operating in such an environment should have the same opportunity to assert the ordinary course of business exception."[1]

The Bankruptcy Code provides creditors with considerable latitude to establish what terms or practices are ordinary in the relevant industry. In fact, one particularly broadminded court stated that "[o]nly a transaction that is so unusual or uncommon 'as to render it an aberration in the relevant industry,' falls outside the broad range of terms encompassed by the meaning of 'ordinary business terms.'"[2]

Case law reveals numerous factors that courts are likely to consider when evaluating whether payments made under a debt restructuring agreement fall within the ordinary course of business defense. Creditors can use these factors to guide their negotiations and draft debt restructuring terms to their advantage. The factors include:

- Commonality of restructuring agreements in the particular industry.
- Typical terms of such agreements (including payment frequency, duration of repayment period and interest rate).
- Whether credit enhancements such as collateral or guarantees are commonly procured by creditors in the industry in conjunction with such agreements.
- Whether new debt instruments such as a promissory note were executed.
- Whether the parties actively negotiated the agreement.
- Whether the debtor provided value (e.g., a restructuring fee) in consideration for the agreement.
- Whether the creditor agreed to compromise the balance due in exchange for the agreement.
- Whether the creditor used unusual pressure or threats to compel the debtor to enter the agreement.
- Comparison to terms of restructuring agreements entered into by same creditor with other customers.

In addition, it is important to review any recent case law on restructuring agreements in the state or states where the customer might file for bankruptcy. Even though preference actions are governed by federal law, the prevailing attitude toward allowing payments under such agreements to qualify for the ordinary course of business defense varies by jurisdiction.

CONCLUSION

Accepting payments under a debt restructuring agreement with a financially distressed customer will leave an unsecured creditor with preference liability exposure if the customer subsequently enters bankruptcy. This risk can be mitigated, but never eliminated, by carefully tailoring the agreement to track closely the applicable industry's customary terms and practices to the extent they can be identified, documented, and later proven. Most creditors would rather be paid now and live with the risk of potential disgorgement later, but savvy creditors will explore the optimal terms of repayment to minimize preference risk and structure their deals accordingly.

1 *Lawson v. Ford Motor Co. (In re Roblin Industries, Inc.)*, 78 F.3d 30, 32 (2nd Cir. 1996).

2 *Ganis Credit Corp. v. Anderson (In re Jan Weilert RV, Inc.)*, 315 F.3d 1192, 1198 (9th Cir. 2003) (internal citations omitted).

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