



CLLA HILL DAY

March 2-3, 2015

BANKRUPTCY PREFERENCE REFORM

1) PROPOSAL

Provide for a mechanism to ensure that preference actions are filed in good faith; allow for a safe harbor for pre-bankruptcy consensual settlements with the debtor; and also require that actions for the recovery of \$50,000 or less be commenced where the preference defendant resides.

2) BACKGROUND

Although the Code's preference statute has achieved, for a large part, the balance it sought to strike between *creditors*, it has produced an uneven playing field as between creditors and a trustee or debtor-in-possession allowing the latter to, in essence, hold a creditor hostage by requiring that the creditor either agree to a significant judgment in settlement or spend even greater costs in litigating the preference claims in proving up its defenses. In both large and small bankruptcies, trustees or debtors-in-possession commonly issue preference demands to, or commence adversary proceedings against, every unsecured creditor who received a payment from the debtor within 90-days prior to bankruptcy filing with little to no analysis at all on the part of the trustee or debtor in possession regarding the circumstances surrounding the payment or transfer or whether any of the applicable defenses apply. Even the defense of a small preference claim can be unduly expensive causing creditors to unnecessarily negotiate a settlement in compromise of the asserted claims.

3) WHY PREFERENCE REFORM IS NECESSARY

Quite often, the only significant connection that a creditor has with a bankruptcy case is when it is contacted to disgorge a preferential payment. At first glance, the trustee or debtor-in-possession's action seems completely unfair and arbitrary, only increasing the creditor's other losses caused by the debtor. Thus it is imperative for the bankruptcy process and system that avoidance actions, especially preferences, are conducted fairly and with an eye toward advancing the main purpose of the law – the equality of treatment of similarly situated creditors. However, in practice that has not always been the case.

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- The *National Bankruptcy Review Commission, The Next Twenty Years (1997)* reviewed various surveys of attorneys and credit managers regarding preference experiences and acknowledged that smaller trade creditors are particularly susceptible to abusive litigation tactics by the trustee or debtor-in-possession. (*Id.*, p. 797).
- Subsequently, in the *American Bankruptcy Institute Commission to Study the Reform of Chapter 11 (2012-2014)*, the Commission reported that it had held special hearings on preferences and determined that often preference actions were filed without regard to the merits of the claim and were actually designed more to extract settlement payments from a defendant than to pursue the merits of the claim (*Id.*, p. 150).
- These abuses are highlighted especially in larger Chapter 11 cases that are filed in remote bankruptcy locations. There a preference defendant will be often be stuck with a “Hobbesian Choice”, i.e., to have local counsel defend the litigation or to pay for a settlement to quickly resolve the matter before attorneys' fees surpass the prayer of the complaint. *See*, http://www.clla.org/resources/venue_reform.cfm for background on bankruptcy forum shopping abuses and consequences. It is estimated that at least \$50,000 must be at issue to justify hiring local counsel to defend an out of state action. (*See, ABI Commission Report* also recommends a \$50,000 threshold).

4) SUGGESTED REFORM

Therefore, the CLLA recommends the following reform measures to 11 U.S.C. § 547 and 28 U.S.C. § 1409(b) regarding the treatment of preferential transfers claims:

A. First, the CLLA recommends that 11 U.S.C. § 547(c) be amended to provide an additional affirmative defense to creditors that cooperate and settle with a debtor before a bankruptcy case is filed.

B. Second, the CLLA recommends that section 547 be amended to require that the trustee or the debtor-in-possession “meet and confer” with the creditor both prior to and as a condition of the filing of any adversary proceeding against the creditor seeking the recovery of an alleged preferential transfer. This “meet and confer” requirement would further require the trustee or debtor in possession provide the creditor with financial information relevant to the claim and possible defenses to the alleged preference claim.

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C. Third, the CLLA recommends changing the dollar limits in 28 U.S.C. § 1409(b) from the current amount of \$12,475 to \$50,000 on a non-insider commercial preference claim.

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