CLLA HILL DAY

February 28 – March 1, 2016

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 and has resulted in "strong frustrations with preference law." *American Bankruptcy*

Institute Commission to Study the Reform of Chapter 11 (2012-2014) (the "ABI Report") p. 150).

4) **SUGGESTED REFORM**

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.**

- At the May 21, 2013 Public Field Hearing held by the ABI Commission to Study the Reform of Chapter 11, Valerie Venable, CCE, Director of Credit, Ascend Performance Materials, LLC, Houston Texas highlighted through her testimony the need for bankruptcy reform as it relates to creditor cooperation with a financially troubled debtor and the disincentive that exists to help a troubled debtor, for fear that the assistance will only result in a bankruptcy preference suit later. Ms. Venable stated:

- "I sell raw material, used in manufacturing – little plastic pellets that go into everything from underwear to carpet to tires. When a customer of mine has financial difficulties, it is not uncommon for me to work out a deal with the debtor which allows them additional time to pay me, either as it sells my goods, or with a repayment plan that allows the debtor funds to run their business through a period of temporary cash flow constraints. This not only helps the debtor keep the lights on, but also allows my company to continue to build a strong business relationship. In all honesty, sometimes this strategy pays off, but sometimes I just end up with a higher balance due or opening myself up for a potential preference exposure should the debtor ultimately fail. Because of the fear that a payment will have to be given back, some creditors, in order to preserve their own company's assets, will make a business decision not to continue to sell to a troubled business rather than try to find a way to get them enough product to keep them in business. This lack of willingness to work with the debtor may protect the creditor, but may also serve as a catalyst to eventual business failure." (Id., p.3).

- Ms. Venable went on to testify as follows: "Yet, the whole time I am working with the debtor, allowing slower payments, in order to keep the debtor in business, I have to keep weighing the potential impact of a subsequent Chapter 11 or Chapter 7, where a demand for repayment will

be made to me because those payments were not "ordinary". Even a formal adjustment of terms for a quantifiable valid business reason has worked against me. When I receive the letter asking for recovery of a preference, or worse, a notice of a complaint being filed, I am presumed guilty until proven innocent. And to prove my innocence is going to be costly and time consuming and in some cases more risky than selling to the distressed debtor." (Id., pp3-4).

B. **<u>Second</u>, 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.**

- The *American Bankruptcy Institute Commission to Study the Reform of Chapter 11 (2012-2014)* recommends that demand should not be issued or a complaint be filed unless "based on reasonable due diligence, the trustee believes in good faith that a plausible claim for relief exists against such party under section 547, taking into account the party's known or reasonable knowable affirmative defenses under section 547(c)." ABI Report at p. 148

- The *National Association of Credit Management Introduction and Position Brief 2015* contains the following recommendation regarding this issue: "NACM and the trade credit community believe there should be a requirement that the trustee conduct due diligence to determine whether a preference claim exists before making demand upon a creditor." NACM recommends that a "due diligence" threshold be incorporated in to Section 547 (b), as a prerequisite to the filing of any preference action. NACM has proposed that "due diligence" mean "a determination by the trustee that there are reasonable grounds to believe, in good faith, that a plausible claim for avoidance exists after taking into account the known or reasonably ascertainable defenses under 547(c) and should include a "new value" analysis for the purposes of Section 547(c)(1) and Section 547(c)(4) and an ordinary course of business analysis for the purposes of Section 547(c)(2)." (Id., p.2).

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.**

- 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. 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).

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