

“Defending Preference Actions”©

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1. **Current Issues Regarding Defending Preference Actions - § 547(c)**
 - (a) **Limits of Contemporaneous Exchange Defense - § 547(c)(1)**
 - (i) Parties to transaction must have requisite intent AND exchange must in fact be contemporaneous; Intention alone is insufficient.
 - (ii) Replacement payment for dishonored checks is not a contemporaneous exchange. *See, e.g., Endo Steel, Inc. v. Janas (In re JWW Contr., Co.)*, 371 F.3d 1079 (9th Cir. 2004) (exchange was not contemporaneous despite intent where debtor replaced a dishonored check with a cashier's check 11 days after receipt of the goods)
 - (b) **Ordinary Course Defense and BAPCPA Changes - § 547(c)(2)**
 - (i) Under BAPCPA, the ordinary course defense was expanded to apply where the suspect transfer was either:
 - (1) (1) in the ordinary course as specifically between the debtor and the transferee (subjective test); OR
 - (2) (2) in the ordinary course for the debtor's industry (objective/industry standard test)
 - (ii) Prior to BAPCPA, the ordinary course defense required proving both the subjective and objective tests
 - (iii) Subjective Test / Duration of Relationship
 - (1) If challenged transfer arises from initial transaction between the debtor and the transferee, the transaction may nevertheless satisfy the ordinary course requirement. *See In re Ahaza Sys., Inc.*, 482 F.3d 1118 (9th Cir. 2007) (looking to parties' practices with others to determine ordinary course with regard to initial transaction); *In re Russell Cave Co., Inc.*, 259 B.R. 879 (Bankr. E.D. Ky. 2001) (indicating terms of written agreement between parties can define ordinary course in absence of history of transactions)
 - (c) **Subsequent New Value Defense - § 547(c)(4)**
 - (i) Circuit split in calculating New Value
 - (1) Remains Unpaid Approach (3d, 7th, and 11th Circuits) - Requires that the new value provided by the creditor must remain unpaid at the end of the preference period in order

to be effectively used by the creditor to offset its preference liability. See Noah Falk, *Section 547(c)(4): The Subsequent New Value Exception Defense to Preferences*, 2004 Ann. Surv. of Bankr. Law Part I., §Q (Norton Oct. 2004); but see *In re Pillowtex*, No. 03-12339 (Bankr. D. Del. filed Oct. 15, 2009) (opening door for creditors in the 3d. Circuit to apply subsequent advance approach).

- (2) Subsequent Advance Approach (4th, 5th, and 9th Circuits) Apply the more pragmatic and broader "subsequent advance" approach. *Id.*
- (3) The "remains unpaid" approach significantly increases the preference exposure for creditors whose prepetition dealings with a debtor were done on a "running" or "rolling" account basis because that creditor loses the ability to use any provisions of new value that are made between avoidable preference payments by the debtor. Under the "remains unpaid" approach, the creditor gets credit for new value that is provided only after the last avoidable preference payment received from the debtor. That is, under the "remains unpaid" approach, the creditor simply loses the ability to offset any new value the creditor may have provided during the "sandwich period" – the period sandwiched between two preferential payments by the debtor. By contrast, the "subsequent advance" does not deny the creditor credit for new value provided during the sandwich period. The "subsequent advance" approach recognizes the reality of a rolling account relationship by offsetting the aggregate payments received by the creditor by the aggregate new value given by the creditor during the preference period. Therefore, the "subsequent advance" approach prevents a trustee from eliminating the effect of the new value defense when the new value is provided by the creditor during the sandwich period.
- (4) As shown in the following chart, the "subsequent advance" approach significantly reduces a creditor's preference exposure in rolling account situations.

Date	Alleged Preference Pmt.	New Value Given	Preference Exposure (Subsequent Adv.)	Preference Exposure (Remains Unpaid)
1/10/2009	\$ 1,000		\$ 1,000	\$ 1,000
1/20/2009		\$ 1,000	\$ -	\$ -
1/30/2009	\$ 1,000		\$ 1,000	\$ 2,000
2/10/2009		\$ 1,000	\$ -	\$ 1,000
2/20/2009	\$ 1,000		\$ 1,000	\$ 3,000
3/1/2009		\$ 1,000	\$ -	\$ 2,000

(d) **Improvement of Position on Floating Liens in Inventor or AR - § 547(c)(5)**

- (i) Under § 547(c)(5), the claim of holder of a perfected security interest in inventory or receivables will not be avoidable as preference unless and only to the extent such holder improves his position during the 90 day preference period
- (ii) To determine whether a creditor improves its position for purposes of § 547(c)(5), the court compares the amount of outstanding debt to the value of the collateral securing the debt at the beginning and end of the appropriate preference period. There is no improvement in position so long as the deficiency at the beginning of the preference period is equal to or smaller than the deficiency at the end of the preference period. *In re Touse, Inc.*, 2009 Bankr. LEXIS 2535 (Bankr. S.D. Fla. 2009)

(e) Earmarking

- (i) Funds provided to a debtor for the purpose of paying a specific indebtedness may not be recoverable as a preference from the creditor to which they are paid on premise that property transferred in such a situation was never property of the debtor and so the transfer did not disadvantage other creditors.
- (ii) The earmarking doctrine will not protect a creditor who failed to timely perfect his security interest when refinancing debt which was previously properly perfected. *See Collins v. Greater Atlantic Mortg. Corp. (In re Lazarus)*, 478 F.3d 33 (1st Cir. 2007) (lack of prejudice is not a substitute for formal compliance)