New Jersey Law Journal

VOL. CLXXIX – NO. 12 – INDEX 1162 MARCH 21, 2005 ESTABLISHED 1878

BANKRUPTCY LAW

The Preference Problem

Creditors are held hostage to baseless claims

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The framework designed by Congress to avoid preferential transfers within the 90-day period prior to a bankruptcy filing is broken. In many bankruptcy cases, trustees and plan administrators commence hundreds of actions to recover each and every payment made by a debtor within 90 days of the commencement of a bankruptcy case, with no regard to the statutory defenses which clearly apply to the claims which they raised. Defendants are then forced to dedicate resources to defend baseless actions and demonstrate that allegedly preferential transfers fall within one or more of the available statutory defenses.

Local bankruptcy rules frequently require defendants to retain counsel in the jurisdiction where the action is commenced to enter an appearance and file an answer, adding an additional cost. When the facts underlying these actions are closely examined, and it is determined that there is no liability on the part of the entity being sued, counsel for the debtor may nevertheless insist that the defendant pay some token amount or waive its proof of claim to make the case go away.

The pervasive misuse of the preference statute is having a negative economic effect upon companies that continue to do business with troubled companies. Rather than encouraging normal business operations and sales to troubled companies, many businesses have (or should) scrutinize their policies when conducting business with a company in the throes of business difficulties, and seriously consider the added costs that will be incurred when the inevitable lawsuit is commenced after a bankruptcy filing.

Congress could not have envisioned that a statute which was originally designed to preserve creditor equality and foster normal business relations with troubled companies would be used in a manner directly contrary to these goals.

The Preference Statute's Purpose

A "preference" is defined in 11 U.S.C. §547(b). The elements of a preferential transfer are straightforward: (1) a transfer of the debtor's property; (2) to or for the benefit of a creditor; (3) for or on account of an antecedent debt owed by the debtor before such transfer was made; (4) made while the debtor was insolvent; (5) within 90 days before bankruptcy; (6) the effect of which transfer was to give the creditor more than it would otherwise have received in a Chapter 7 distribution.

The legislative history of Section 547 describes the purpose of the legislation:

> A preference is a transfer that enables a creditor to receive payment of a greater percentage of his claim against the debtor than he would have received if the transfer had not been made and he had participated in the distribution of the assets of the bankrupt estate. The purpose of the preference section is two-fold. First, by permitting the trustee to avoid pre-bankruptcy transfers that occur within a short period before bankruptcy, creditors are discouraged from racing to the courthouse to dismember the debtor during his slide into bankruptcy. The protection thus afforded the debtor often enables him to work his way out of a difficult financial situation through cooperation with all of his creditors. Second, and more important, the preference provisions facilitate the prime bankruptcy policy of equality of distribution among creditors of the debtor. Any creditor that received a greater payment than others of

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> his class is required to disgorge so that all may share equally. The operation of the preference section to deter "the race of diligence" of creditors to dismember the debtor before bankruptcy furthers the second goal of the preference section — that of equality of distribution. H.R. REP. NO. 95-595, at 177-78 (1977), reprinted in 1978 U.S.C.C.A.N. 5963.

Consistent with the legislative purpose, Congress enumerated eight defenses which are available to transferees in those cases where the payments they received otherwise fall within the definition of a preferential transfer, which are designed to encourage creditors to continue dealing with troubled businesses by eliminating concerns that a subsequent bankruptcy filing might require a creditor to forfeit a payment it received within ninety days of a filing. See *Barnhill v. Johnson*, 503 U.S. 393, 402 (1992). These defenses include that the payment was: (a) a contemporaneous exchange for new value; (b) made in the ordinary course of business; and/or (c) was followed by the extension of new unsecured credit. Certain of these defenses simply require an accounting exercise to determine whether a payment can be avoided while other defenses require a more fact-intensive investigation. Often, preference actions are commenced when no investigation has occurred, even though a defense to the action is facially obvious or becomes obvious after minimal due diligence is conducted.

Baseless Preference Actions

A trustee has a period of two years following the commencement of a bankruptcy case to commence preference actions. But many times, debtors are too pressed with the business of reorganizing their businesses to focus on dealing with preference issues until the deadline is about to expire. As a result, in many bankruptcy cases, trustees and plan administrators initiate preference actions against each and every entity that received a transfer within 90 days of the original filing date on the eve of the expiration of their statutory deadline without considering whether any of the statutory affirmative defenses apply to the transfers. This results in the commencement of hundreds, if not thousands, of preference actions that would never be commenced if the plaintiff actually considered whether there were any available defenses. In 2004, the United States Bankruptcy Court for the District of Delaware reported that more than 13,000 preference cases were pending in that jurisdiction alone. *In re Lenox Healthcare, Inc*., 311 B.R. 404, 409 n.4 (Bankr. D. Del. 2004). The use of computers has compounded the problem by making it possible for debtors to prepare boilerplate complaints and discovery requests that cost very little to prepare per adversary proceeding, since the cost is spread out among hundreds of cases. Unfortunately, once an adversary proceeding is filed and the summons and complaint are served, the cost to defend the case can run into the thousands of dollars fairly quickly, regardless of whether the action is meritorious.

Arguably, Rule 9011 of the Federal Rules of Bankruptcy Procedure, the analog to Federal Rule of Civil Procedure 11, should act as a bar to the commencement of many preference actions. Rule 9011 requires all attorneys to make reasonable inquiry into whether the factual contentions that are made have evidentiary support, and provides that sanctions may be imposed for failing to do so. Fed.R.Bankr. Proc. 9011(b). Further, what constitutes a reasonable prefiling investigation is judged by an objective standard, not by plaintiff's subjective determination. Rule 11 sanctions are based on an objective standard of reasonableness under the circumstances, and bad faith is not required. *Martin v. Brown*, 63 F.3d 1252, (3d Cir. 1995); *Mary Ann Pensiero, Inc. v. Lingle*, 847 F.2d 90, 94 (3d Cir. 1988).

In discussing the general obligations under Rule 11, one court has stated that "[p]art of a reasonable attorney's prefiling investigation must include determining whether any obvious affirmative defenses bar the case." *White v. General Motors Corp*., 908 F.2d 675, 682 (10th Cir. 1990), cert. denied, 498 U.S. 1069 (1991); see also *Babb v. Bridgestone/Firestone*, 861 F.Supp. 50, 53 (M.D. Tenn. 1993) (noting that plaintiff would be justified in filing a complaint if it had a nonfrivolous argument that a known affirmative defense was inapplicable). Despite the general language that a plaintiff should investigate obvious affirmative defenses, bankruptcy courts have been reluctant to sanction attorneys for pursuing preference actions where the facts establish a prima facie case. See e.g., *In re Excello Press*, *Inc*., 967 F.2d 1109 (7th Cir. 1992); *In re Berger Industries, Inc*., 298 B.R. 37 (Bankr. E.D.N.Y. 2003). These courts have stated that the trustee's Rule 11 obligations are satisfied if the trustee is able to demonstrate that the five elements of a preference have been met, and have not required a trustee to examine affirmative defenses to the preference claim except in "unusual or extreme circumstances." *Excello*, 967 F.2d at 1113.

The effect of these decisions has been to remove or curtail obligations that apply to plaintiffs in nonbankruptcy litigation in federal courts, and to shift the cost of investigating the merits of preference complaints from the plaintiff debtor, to the defendant creditors after the lawsuit has been commenced. In a very real sense, the preference statute as it is presently enforced, imposes a cost on parties who do business with distressed companies, since they are exposed to defending preference actions after a bankruptcy filing, regardless of the terms under which they conducted their business. In an era where frivolous litigation costs are under examination in every sector of the economy, more attention needs to be paid to what is occurring in Bankruptcy Court every day of the week.

The current preference statutes have spawned a system in which aggressive debtors, trustees and plan administrators are allowed to pursue lawsuits when the merits of the claim are not supportable, and apply salt to raw wounds that many preference defendants have already suffered. Since many preference defendants are also creditors of a bankruptcy estate, those entities are paid only a fraction of what they are owed in bankruptcy dollars, and are then forced to defend lawsuits of questionable merit.

The preference statutes were designed to foster equality among credi-

tors to encourage suppliers of goods and services to keep doing business with financially troubled companies. The preference statutes were not designed and should not be applied in a manner contrary to these purposes.

The most direct means to fix this problem is for courts to impose a duty on plaintiffs under Rule 9011 to fully investigate whether affirmative defenses to a preference claim prior to commencing a preference action. For example, since a new value analysis can be a simple accounting exercise, trustees or plan administrators should be compelled to conduct such analysis prior to filing a complaint. Similarly, trustees should be required to analyze the invoice and payment histories for potential preferences to determine whether the payments in question are subject to ordinary course defense.

Alternatively, local bankruptcy courts might consider enacting separate sets of rules which would require debtors to engage in some form of preference analysis following the commencement of a case and shift the initial cost burden of considering the statutory defenses to the debtor rather than the debtor's creditors.

The preference system can and should be fixed to comport with the statutory purpose to foster creditor equality, and discourage a race among creditors to get paid, without imposing undue litigation costs on every creditor as the price for doing business with a troubled company. ■