

Preference Payments
Bankruptcy Code Section 547

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I. Preference Payments Defined

- a. § 547(b) allows the trustee to avoid (set aside) transactions involving any transfer of an interest of the debtor in property:
 - i. to or for the benefit of a creditor;
 - ii. for or on account of an antecedent (past due) debt owed by the debtor before the transfer was made;
 - iii. made while the debtor was insolvent;
 - iv. made –
 - 1. on or within 90 days before the petition date; or
 - 2. on or within one year before the petition date, if made to an insider; and
 - v. the creditor received more than it would have received if –
 - 1. the case was administered under Chapter 7;
 - 2. the transfer had not been made; and
 - 3. the creditor received payment of such debt to the extent provided by the provisions of the Bankruptcy Code.
- b. Trustee (debtor-in-possession) must establish all five elements by a preponderance of the evidence to avoid a transaction as preferential.
- c. Goal: Equal distribution of debtor's property to creditors. The elements are not subjective and do not require intent, notice of insolvency, or fraud.
 - i. § 547 differs from § 548 fraudulent transfers—which focuses on whether debtor received a reasonably equivalent value, or whether the transfer was made with actual intent to hinder, delay, or defraud creditors.

II. Defense – Negating Essential Elements

- a. "Transfer" is broadly defined as "every mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with property or with an interest in property." Transfer does not include (therefore, not avoidable):
 - i. Payments made on behalf of debtor by third parties.
 - ii. Payments made by debtor in fiduciary capacity (executor/trustee).
 - iii. "Earmarking Doctrine" – Paying creditors with funds received from third parties who directed how the funds **must** be applied.
 - 1. Earmarked payments are not preferential because debtor never had equitable (direct) benefit of the funds.
 - a. The third party would not have given the debtor money **but for** the debtor's agreement to pay a designated creditor.
- b. Transfer must be for an antecedent debt.
 - i. Cash-on-delivery, cash-on-order, or prepaid accounts are *not* antecedent debts and are not avoidable.

- ii. Contemporaneous bona fide sales are *not* antecedent debts and are not avoidable.
 - iii. Gifts are not preferential transfers because they are not made on account of antecedent debts.
 - iv. Caution: transaction terms must be for a contemporaneous transfer. Funds should not be applied to previously owed amounts.
- c. Solvency – if a creditor can prove, commonly through expert testimony, that debtor was solvent (assets exceeding liabilities) at the time of transfer, the transaction is not avoidable.
- i. Debtor is presumed insolvent during the 90 days (one year, if insider) preceding the petition date, which satisfies trustee's burden of proof *unless* creditor brings forth evidence supporting solvency. In that event, trustee must prove insolvency by a preponderance of the evidence.
 - 1. Insider: ability to control or influence the debtor's decisions or actions (relatives, general partners, shareholders (20% or more), officers/directors, etc.).
- d. Transfers made 91 days or more (one year and one day or more, if insider) before a bankruptcy petition is filed cannot be avoided.

III. Defenses

- a. § 547(c)(1): Contemporaneous Exchange of New Value
- i. Must prove:
 - 1. Creditor extended new value to debtor in exchange for payment;
 - 2. Transfer was "substantially contemporaneous" with the tender of new value to the debtor; and
 - 3. Parties intended exchange to be contemporaneous.
 - ii. "New Value" must be money or money's worth in goods / services.
 - 1. Providing debtor new credit may suffice.
 - 2. Debtor's issuance of a promissory note is likely not contemporaneous (deferred payment date).
- b. § 547(c)(2): Transfer in Ordinary Course of Business (most difficult defense)
- i. Creditor must prove:
 - 1. Debt was incurred in ordinary course of business or financial affairs of debtor and transferee (ordinarily incurred); and
 - 2. Payment was made in ordinary course of business or financial affairs of debtor and transferee (ordinarily paid); or
 - 3. Payment was made according to ordinary business terms (industry standard);
 - ii. In determining the above-elements, courts often consider the
 - 1. amount transferred
 - 2. timing of the payments

3. historic course of dealings between the debtor and transferee; and
 4. circumstances under which the transfer was effected.
- c. § 547(c)(3): New Value and PMSI interest.
- i. Purchase Money Security Interest (PMSI) not avoidable if debtor can prove by a preponderance of the evidence, that:
 1. Security interest secures new value that was given at or after a security agreement was signed;
 2. Security agreement describes the collateral;
 3. Security agreement is given to enable the debtor to acquire the property, who does in fact acquire the property;
 4. Security Agreement is perfected w/i 30 days of debtor's receipt of property;
- d. § 547(c)(4): Transfers made before New Value
- i. The essential elements are:
 1. Creditor extended new value to debtor *after* preferential payment was made;
 2. The new value was not secured by an otherwise unavoidable security interest; and
 3. on account of which new value the debtor did not make an otherwise avoidable transfer to or for the benefit of such creditor.
 - ii. Protection allowed to encourage creditor's continued dealings with debtor.
 1. Creditor will need to retain records (up to four years) in order to prove the preferential debt was satisfied by subsequent shipments or use of credit.
 - iii. Each dollar of preference payment may be set off against each dollar of new value (dollar for dollar reduction).
- e. § 547(c)(5): Security Interest in Inventory / Receivable; Unsecured Creditors not Impaired:
- i. Defense is allowed so long as creditor has not improved its own position, or prejudiced that of unsecured creditors.
 - ii. Allowed because of the revolving nature of inventory; designed to protect substitutions of comparable or after-acquired inventory.
- f. § 547(c)(6): Statutory Liens
- i. So long as not avoidable under § 545, statutorily created mechanics liens, tax liens, landlord liens, etc., are not avoidable.
- g. § 547(c)(7): Alimony or Child Support Payments
- i. Bona fide payments of alimony, support, and maintenance made pursuant to divorce decree are not avoidable.
- h. § 547(c)(8), (9): Property transferred with an aggregate value of \$600 or less (individuals w/ primarily consumer debt) or \$5,000 or less (not primarily consumer debt) are not avoidable.

- i. § 546(d) subjects a trustee's preference claim to common law and statutory rights of grain producers and fisherman to reclaim such grain or fish.
- j. Statutory Trusts: *e.g.*, Perishable Agricultural Commodities Act (PACA) imposes trust on proceeds derived from fresh fruit and vegetable sales.
 - i. Statutory Trusts prime the rights of other claimants and lien holders and excludes such property from the bankruptcy estate.
 - 1. Therefore, trustee may not establish requisite preference elements (debtor does not have an interest in the transferred property).
- k. State Laws: *e.g.*, Builders Trust Fund Act (BTFA)
 - i. Payments to contractors are deemed held in trust for benefit of subcontractors and other similar laborers.
 - ii. Not considered part of the bankruptcy estate. Not recoverable because debtor has no interest in the property.
- l. Conduit transfers: Conduits are not liable for preferential payments (*e.g.*, depository bank that receives funds from Person A before transferring the funds to Person C).
 - i. First transferee is either "conduit" (not liable) or "initial transferee," who is often strictly liable to trustee for transactions avoidable under § 547.
 - 1. Deciding factor is whether person had dominion and control of assets. If so, person is "initial transferee," and is liable; if not, the person is a mere "conduit," and is not liable.
 - ii. Transferee who receives assets from initial transferee in good faith potentially *not* liable and neither are subsequent transferees (shelter rule).

IV. Tips for Avoiding Preferential Payment Claims

- a. Use cash-on-delivery / cash-on-order procedures (no antecedent debt; new value defense).
- b. Require third party guarantors, whose payments do not come from estate property and therefore are not preferential.
- c. AVOID post-dated checks because courts may deem them not in the ordinary course of business.
 - i. Further, checks may be deemed transferred when honored not received (may affect the 90 day (one year for insiders) calculations).
- d. Utilize consistent credit policies and maintain accurate records, both of which are essential for an ordinary course of business defense.