Addressing the Unexpected Preference Risk for Creditors
Paid Pre-Petition Claims Pursuant to Court Order

The recent decision of the United States Bankruptcy Court for the District of Delaware in Friedman’s Inc. v. Roth Staffing Cos., L.P. (In re Friedman’s Inc.) should be a reminder of the preference risk that exists for creditors, such as critical vendors, whose pre-petition claims are paid by court order. This article discusses various ways in which this preference risk can be eliminated or minimized.

The pre-petition claims held by certain creditors, such as vendors who supply critical goods, are often paid in full by a debtor at the outset of its bankruptcy case pursuant to court order. Court orders authorizing such payments are often obtained by the debtor due to concern that the vendor will not continue supplying goods or providing services unless its pre-petition claim is paid in full at the outset. Such creditors are commonly referred to as critical vendors. Other creditors, such as employees, are also often paid their pre-petition claims at the outset of the case pursuant to court order. A creditor may logically assume that if its pre-petition claim is paid pursuant to such an order it is no longer at risk of being sued to give back any payments it received from the debtor during the 90-day preference period prior to the commencement of the bankruptcy case. After all, the court order authorizing payment of the pre-petition outstanding balance likely would have also authorized the payment of any additional pre-petition sums owed to the creditor had such sums not been paid during the preference period and no longer outstanding at the time the court order was entered.

However, this is not the case. Payment of a creditor’s pre-petition claim pursuant to such a court order does not prevent the debtor (or a trustee on behalf of the debtor) from later bringing an action against such creditor to recover preferential transfers. Nor does the creditor possess a defense to such an action based on having received payment of its pre-petition claim pursuant to court order. As a result, a creditor who receives such payment often – to its surprise – subsequently finds itself a defendant in a preference action. Nevertheless, as discussed below, a critical vendor or other creditor in a similar situation can take action to avoid later getting sued to return preferential payments.

The following common scenario is illustrative: A supplier of a debtor receives $2 million in payments from such debtor during the 90 days prior to the date the debtor files its chapter 11 petition. At the time the petition is filed the supplier is owed $500,000 and has a pre-petition claim against the debtor for such amount. In order to ensure that the supplier continues to supply goods, the debtor obtains a court order simply authorizing it, at its discretion, to pay the supplier’s $500,000 pre-petition claim as a critical vendor (subject to certain conditions). The debtor does in fact pay the supplier’s pre-petition claim. The debtor’s plan of reorganization is eventually confirmed by the bankruptcy court. A litigation trustee later asserts a preference action against the supplier seeking to recover the $2 million in payments that the supplier received from the debtor during the preference period. In this scenario, the supplier, i.e., the critical vendor, would have no defense to the preference action based on the fact that its outstanding pre-petition claim was paid pursuant to the court order.
A creditor in this situation can however seek to protect itself against a future preference action. Such creditor – if it has any leverage – should insist that the debtor agree to release any preference claims it may have against such creditor. The mechanics of this can be accomplished in several different ways.

Alternatively, if there is a pre-petition supply agreement between the creditor and the debtor, the creditor should insist that the debtor assume such agreement rather than simply treating the creditor as a critical vendor. In the event the debtor assumes the agreement, the creditor counterparty to the agreement is protected from a subsequent preference action as courts have barred preference actions where executory contracts are assumed. This is principally due to the fact that section 365 of the Bankruptcy Code requires that all pre-petition obligations with respect to an executory contract be satisfied as a condition to assuming the contract.

If the creditor is unable to obtain a release or arrange for an existing pre-petition supply agreement to be assumed, there are still actions that it can take to make it less likely that a subsequent preference action is brought against it and if an action is brought against it to preserve its subsequent new value defense under section 547(c) of the Bankruptcy Code based on the invoices paid pursuant to the court order.

Finally, even if the creditor cannot obtain any of the foregoing and a preference action is subsequently brought against it, the creditor can take the position that the post-petition payment of its pre-petition claim pursuant to the court order does not defeat its use of the invoices that have been paid pursuant to such court order in a subsequent new value defense under section 547(c) of the Bankruptcy Code. Several courts have held that a creditor whose pre-petition claim is subsequently paid post-petition (including the recent In re Friedman’s decision mentioned above) may still use such pre-petition claim as part of a subsequent new value defense, although the issue is not totally free from doubt.

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2 Section 547(b) of the Bankruptcy Code, which is the section dealing with preferences, provides:

(b) Except as provided in subsections (c) and (i) of this section, the trustee may avoid any transfer of an interest of the debtor in property—
(1) to or for the benefit of a creditor;
(2) for or on account of an antecedent debt owed by the debtor before such transfer was made;
(3) made while the debtor was insolvent;
(4) made—
(A) on or within 90 days before the date of the filing of the petition; or
(B) between ninety days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider; and
(5) that enables such creditor to receive more than such creditor would receive if—
(A) the case were a case under chapter 7 of this title;
(B) the transfer had not been made; and
(C) such creditor received payment of such debt to the extent provided by the provisions of this title.

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4 See In re Superior Toy & Mfg. Co., 78 F.3d 1169, 1174 (7th Cir. 1996); Seidle v. GATX Leasing Corp., 778 F.2d 659, 666 (11th Cir. 1985).

5 There are several defenses that a creditor may raise to a preference action – including the subsequent new value defense – which is contained in section 547(c)(4) of the Bankruptcy Code.

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