MEMA
Managing the Meltdown: An Examination of Creditors’ Bankruptcy Strategies

KRC&L
ATTORNEYS & COUNSELORS
INTRODUCTION

BASIC PREMISE APPLICABLE TO UNSECURED CREDITORS IN BANKRUPTCY

unsecured creditors + bankruptcy =
unsecured creditors + bankruptcy =

D’OH!
INTRODUCTION

BASIC PREMISE APPLICABLE TO UNSECURED CREDITORS IN BANKRUPTCY

unsecured creditors + bankruptcy = D
TODAY’S GOAL

Go through a credit professional’s arsenal to fight back against bankruptcy.
PROGRAM OVERVIEW

MANAGING THE MELTDOWN

I. Credit Professionals’ Strategies
   Where Bankruptcy is on a Customers’ Horizon

II. Maximizing Distributions in Bankruptcy

III. Attack Preferential Transfers:
     I’m Not Going to Take it Any More
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Credit Professionals’ Strategies Where Bankruptcy is on a Customers’ Horizon

• Collection Strategies
• Pre-Bankruptcy Remedies
• Prevention Through Drafting Contracts and Structuring Transactions
• Purchase Money Security Interests
• Involuntary Bankruptcy
Credit Professionals’ Strategies Where Bankruptcy is on a Customers’ Horizon

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Collection Strategies

Information gathering becomes even more critical

- Normal: financial statements, UCC-1s, D&Bs, credit groups
- Must dig deeper – Remember not only a two party dispute, rather you against all other creditors
Collection Strategies

• More Detailed Checklists
  a) Change in corporate structure
  b) Dividends/repay loans to insiders
  c) Balance of inter-company accounts dramatically changing
  d) Payables that are guarantied are being paid ahead of other payables
  e) Change of product lines
  f) Efforts to raise capital (bonds, foreign S-1, bank debt with warrants, etc.)
  g) Pending Lawsuits

• Do not forget salesman/local reps
Collection Strategies

Themes In Decision Making

• Legal costs: Return on investment
• Integrity of management
  • Future considerations
  • Business prospects
• Customer/strategic: geographical, size, etc.
• Consider big picture in addition to merits of the particular lawsuit
• How much is at issue
Collection Strategies

Workout Agreements

- Again – Acquire information; make it part of settlement
- Goal – Amount is key, but only half the equation
- Don’t cause bankruptcy
- Preferential transfer protection
- Don’t extinguish the entire debt until paid in full + 91 days
- Don’t re-try case: Agreed Judgment – even if not filed immediately
- Consider Affidavits/Representation
  - Solvent
  - Goods and performance in full compliance
  - Amounts due and owing without defense on offset
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Pre-Bankruptcy Remedies

Stopping Goods In Transit Under UCC

• Where the seller discovers the buyer to be insolvent, it may stop delivery except for cash including payment for all goods previously delivered under the contract.

• When a Seller discovers the Buyer’s insolvency, the Seller may stop delivery of goods in possession of:
  a) a carrier, or
  b) a bailee (3rd party holding the goods, i.e., an independent warehouse).
Rights of Reclamation Under UCC § 2-702(2)

Reclamation provides unsecured suppliers with a relatively short window of opportunity to regain possession of goods – upon learning of customer’s insolvency – despite not possessing a security interest in inventory

• Applicable to goods received within 10 days of customer’s receipt (some jurisdictions 20 days or within a reasonable time after receipt and 45 days under Bankruptcy Code)
• Written misrepresentation of solvency extends time period to reclaim
• Subject to ordinary course buyers and secured lenders
Pre-Bankruptcy Remedies

**GOAL:** Beginning with the end in mind – seize assets prior to completing Collection Lawsuit

**EXAMPLES:** Attachment, Garnishment, Sequestration, Receivership, and Injunction

**BE READY:** Must Move Quickly and Must Post Bond

**MAKES SENSE:** Larger Dollar Amounts
Pre-Bankruptcy Remedies

Attachment: Unsecured Debt

Defendant/Customer:

(a) Defendant/customer justly indebted to you? and

(b) Not sought for harassment?

AND

(c) Without attachment, you will not collect debt?

(d) Then you also need at least one of the following specific grounds:
Pre-Bankruptcy Remedies

Specific Grounds For Attachment

Defendant/Customer:

• Is not resident of state
• Is about to move from state and has refused to pay or secure debt
• Has hidden or is about to hide his property for the purpose of defrauding creditors
• Is about to remove his property from the state without leaving an amount sufficient to pay its debts
Pre-Bankruptcy Remedies

Specific Grounds For Attachment

Defendant/Customer:

• Is about to or has disposed of all or a substantial portion of assets with an interest to defraud creditors

• Is about to convert all or a substantial part of his property into money for the purpose of placing it beyond the reach of creditors

• Owes debt for property obtained under false pretenses

• Example – 12 year old Scotch
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Prevention Through Structuring

- **Executory Contracts in Bankruptcy**
  
a) Material performance on both sides

b) Cure entire prepetition default and adequate assurance of future performance

  *Examples*: supply/requirements contract; advertising; promotion; additional services by supplier

c) **General rule**: Free country you do not have to sell in bankruptcy – not even by COD

d) **Beware**: Could require you to supply in bankruptcy

  *Examples*: good news / bad news
Prevention Through Structuring

• **Consignments**
  a) Put *Your* goods in the customer’s location
  b) UCC-1 is critical
  c) Favorable bankruptcy treatment

• **Sell to parent or other healthy affiliate**

• **Set up bailment arrangement**
  a) Sell to third party
  b) Customer only orders to fill orders
  c) Reduces customer’s cost of carrying inventory and supplier’s outstanding balance
  d) Goods in bailment generally not subject to bank’s liens
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Purchase Money Security Interests

- Allows supplier to obtain a lien with priority over bank’s security interest as to the supplier’s inventory
Purchase Money Security Interests

- Allows supplier to obtain a lien with priority over bank’s security interest as to the supplier’s inventory

- Rationale: provides “enabling funds”; Bank is no worse off

- Preferential transfer defense: § 547(c)(3) “enabling loan.”
Purchase Money Security Interests

How to obtain a PMSI

(a) determine the state in which the debtor is incorporated
(b) conduct a UCC search
(c) give written notification to existing secured creditors
(d) obtain signed security agreement from customer
(e) file UCC-1 in proper state before delivery of goods (best business practice)
(f) conduct a follow-up UCC-1 search
(g) tickle calendar for 5 years to file a continuation financing statement
Purchase Money Security Interests

BE AWARE:

• Refile continuation in 5 years
• Floating Lien Problem with accounts receivable
• Don’t forget follow-up UCC-1 search
Letter of Credit

An independent obligation of a bank or other financial institution to pay you for goods sold.
Relationships involved in letter of credit transaction
Letter of Credit

Advantageous in Bankruptcy situations

Watch out for:

1. Expiration date

2. Specific instructions to be paid
   - KRCL example
   - MEMA example
Credit Professionals’ Strategies Where Bankruptcy is on a Customers’ Horizon

• Collection Strategies

• Pre-Bankruptcy Remedies

• Prevention Through Drafting Contracts and Structuring Transactions

• Purchase Money Security Interests

• Involuntary Bankruptcy
Involuntary Bankruptcy

- Infrequently used - One-half of one percent (.5%)
- Automatic stay - The most all encompassing injunction in all of jurisprudence
- Easy to do - No evidence, no hearing, just file a two page document
Involuntary Bankruptcy

Strategic Reasons To File Involuntary Bankruptcy

• Debtor is only paying debts that the principal has guarantied
• Removal of property or sales outside the ordinary course of business
• Bank control
• Insider transfers
• Debtor’s selective payments to only certain creditors
• Trapping preferences
• Control location of the bankruptcy case (Ameriserve)
• Incompetent management - Bankruptcy → Trustee or Crisis Manager
• Debtor’s intention to over-collateralize bank
• Judgment creditor is about to levy on unencumbered property
Involuntary Bankruptcy

Commencing an Involuntary Bankruptcy

- Three or more creditors
- Aggregate debt of $14,425
- Creditors cannot be subject to a bona fide dispute
- Sign a two page petition

Key To Victory

- Due diligence before filing involuntary petition is absolutely critical
- Once You File - You can’t “unfile” or dismiss involuntary petition
Involuntary Bankruptcy

Bottom line to unsecured creditors:

• DO DUE DILIGENCE – involuntary bankruptcies are very hard to dismiss

• Consider what is to be gained, i.e. strategic reasons for filing

• Don’t hesitate to use this very powerful weapon
Credit Professionals’ Strategies Where Bankruptcy is on a Customer’s Horizon

• Collection Strategies
  a) Additional information
  b) Themes in Decision Making
  c) Drafting Workout Agreements

• Pre-Bankruptcy Remedies
  a) Stop Goods in Transit
  b) Reclamation
  c) Stop Shipments
  d) Pre-Judgment Remedies

• Prevention Through Structuring Sales
  a) Executory Contract
  b) Consignment
  c) Bailment
  d) Purchase Money Security Interest
  e) Letter of Credit

• Involuntary Bankruptcy
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Maximizing Distributions in Bankruptcies

- 20-Day Administrative Claim
- Postpetition Reclamation
- Critical Vendor
- Making Creditor Committees Work For You
- New Proof of Claim Form
Maximizing Distributions in Bankruptcies

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20-day Administrative Claims
§ 503(b)(9) Claims

Suppliers can receive an administrative claim for the value of any goods received by the debtor within 20 days before the bankruptcy case.
Benefits

1) Converts a prepetition claim into an administrative expense.

2) Not subject to priming by secured creditor, as is case with reclamation claims.

3) Administrative claim must be paid in full as a condition of confirmation of a chapter 11 plan.

4) Potential for a more prompt payment of the “20 day” liability.

Elevates unsecured creditors to same payment status as lawyers.
20-day Administrative Claims
§ 503(b)(9) Claims

Requirements

1. Only for goods sold in the ordinary course of business (i.e., not services).

2. Claimant must timely file the administrative claim.
When and How to File?

1. Pursuant to requirements of any 503(b)(9) procedures approved by the court, or

2. If no procedures are in place, by hiring counsel to file an application with the court.
Recent Developments

Bankruptcy court found that Model UCC §2-105 provides useful guidance for the definition of “goods.” However, section 503(b)(9) does not exclude goods delivered pursuant to a contract the primary thrust of which is provision of services.

In re Pilgrim’s Pride Corp., 421 B.R. 231, 237 (Bankr. N.D. Tex. 2009)
When Does the Debtor Pay the Administrative Claim?

1. Courts exercise discretion in deciding when the claim should be paid, based on: (1) prejudice to the debtor; (2) hardship to the claimant; (3) potential detriment to other creditors.

2. Courts generally will not permit immediate or pre-confirmation payment of the administrative claim.
Strategic focus Blah! Blah! front facing client orientated initiatives Blah! Blah! rich target orientation Blah!

I wonder if they’ll have those cheese and ham paninis at lunch

Only another 20 years until I retire

I wonder if anyone has ever made a statue out of cheese!
Maximizing Distributions in Bankruptcies

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Postpetition Reclamation

• Goods delivered within **45 days** before bankruptcy.

• Notice required no later than **20 days** after bankruptcy.

• Subject to prior rights of a security interest holder.

• If Supplier fails to timely file for reclamation, it can still file for an administrative claim for goods delivered 20 days before bankruptcy.
Maximizing Distributions in Bankruptcies

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The Critical Vendor - Generally

Unsecured trade vendors must typically wait until the confirmation of a plan of reorganization (and often for years after) to receive some payment on their prepetition claims.
The Critical Vendor - Generally

A trend has developed in Chapter 11 cases, in a limited number of jurisdictions, and under very stringent circumstances, to allow payment of the prepetition claims of certain critical suppliers.
The Critical Vendor - Generally

• **WHO?** Suppliers are often described as suppliers whose products are “needed to facilitate the rehabilitation of the debtor” or “critical to the debtor’s reorganization.”

• **HOW?** Debtor’s filing of a motion to pay prepetition balances to certain “critical vendors,” in exchange for the critical vendors’ agreement to supply postpetition unsecured trade credit, and to continue to provide goods or services during the debtor’s bankruptcy case.
The Critical Vendor - Generally

• Many courts decline, arguing such payments upset the priority scheme contemplated by the Bankruptcy Code.

• Possibility of payment under section 503(b)(9) further reduces likelihood of critical vendor treatment.

• Be Proactive—pay close attention to whether a Critical Vendor Motion has been filed...don’t get caught playing Solitaire on your computer!
CAUTION

Critical Vendor and the Automatic Stay

- A trade creditor should **never** directly approach a debtor **after** it files bankruptcy to demand critical vendor status and payment of prepetition amounts owed.
  - Violates automatic stay.
  - Subjects creditor to possible sanctions.
CAUTION

Critical Vendor and the Automatic Stay

• Be careful: At most, the trade creditor might approach its debtor to inquire whether the debtor is considering filing a critical vendor motion.

• Making an actual threat to discontinue doing business absent payment of prepetition amounts is almost certainly a violation of the automatic stay.
The Critical Vendor - Generally

Who Can Be a Critical Vendor?

• Generally, a **debtor** must establish:
  
  (i) it is critical to the debtor’s reorganization chances that the debtor continue to deal with the particular creditor,

  (ii) failure to deal with the creditor risks loss of an economic advantage that outweighs the size of the creditor’s prepetition claim, and

  (iii) there is no practical or legal alternative to payment of the creditor’s prepetition claim, such as through a deposit.
The Bottom Line

- Trade creditors that supply critical goods or services to a debtor may (in a limited number of jurisdictions) have their prepetition claims paid in a manner not expressly authorized in the Bankruptcy Code.

- However, a trade creditor should accept critical vendor status only with open eyes and after close consideration and negotiation of the terms of the trade creditor’s critical vendor status.
Would you excuse me a moment?... Someone's trying to get my attention.
Maximizing Distributions in Bankruptcies

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The Committee – Maximizing Distribution to Unsecured Creditors

- Congress intended unsecured creditors to have a voice – a very strong voice – in reorganization cases.
- “White Hat” – One Bankruptcy Judges’ view
- Congress gave the unsecured Creditors’ an invitation to the party – the Committee must not only RSVP – but must become the life of the party.
  a) Equity rarely has any value “it’s your case”
  b) Hit the ground running – object to financing
  c) Discovery: Bankruptcy Rule 2004
  d) Forensic Accountants
  e) Take over “Debtor’s lawsuits”
  f) Attack liens of Secured Creditors
  g) Develop competing plan
Committee’s Role: Section 1103(c)

• Consult with the trustee or debtor-in-possession concerning administration of the case

• Investigate the acts, conduct, assets, liabilities, and financial condition of the debtor, including the operation of the debtor’s business and desirability of the continuance of such business

• Request the appointment of a trustee or examiner under § 1104 of the bankruptcy code

• So much more – it’s your case!
Committee’s Role: Section 1103(c)

• More times than not, the Committee is out of the money: value of the business is less than the Bank’s debt

• In these out of the money cases, the Committee’s first objective is to create a **seat at the table**
Committee’s Tools of Aggression

- Depositions and 2004 Examination
- Commence adversary proceedings on behalf of the debtor-in-possession
- Investigate D&O issues
- Motion to appoint an examiner or trustee
- Force a Concurrent Sale Process/Slow Down Debtor’s Sale Process
- File competing plans of reorganization
- Object to motions, initiate actions: PIA factor
Attack Bank

• DIP Financing/ Cash Collateral
• Investigate liens and Causes of Action
• Whatever it takes: Convert to Chapter 7
Replace Management

• First Question: tell me about your D&O coverage

• Replace or significantly change management
  a) Clear majority of 20+ Committees
  b) Mutually agreeable crisis or turnaround management
  c) Mutually agreeable professional to run sale process
Appointment of Trustee - § 1104(a)

Strong presumption debtor should be permitted to remain in possession

- Appoint Trustee – best interests of creditors
- If current management committed
  a) Fraud
  b) Dishonesty
  c) Incompetence
  d) Gross mismanagement
  e) Other (Examples: failure to keep accurate records, questionable transactions)

- Best interest of creditors, equity security holders, and other interests of estate
- As an alternative to dismissal or conversion if in best interest of creditors
Forcing A Sales Process - § 363

- Attempt to capture going concern value
- Management/shareholder preservation of equity, jobs, and control versus Committee’s desire to maximize distribution

- Examples
  a) Forcing sale process
  b) Competitive dynamic

- Creating a competitive dynamic before it is too late
  a) Opportunity for buyer
  b) Opportunity for creditors to maximize value
Director and Officer Lawsuits

• Very under utilized weapon

• Upon becoming insolvent, directors owe a fiduciary duty to creditors
  a) states differ upon the precise duty
  b) creditors v. shareholders

• California example
  a) forced sale through involuntary bankruptcy
  b) D&O
  c) Reverse Merger

• Important to use throughout case in negotiations
The Committee - Resources

• Committee often possesses industry information that may be very helpful to the reorganization process (Judge Drain)

• Committees may also be able to provide postpetition financial support (Letter of Credit)

• Committees may be able to locate industry buyers (Several Cases)
How do I Become a Committee Member?
Getting on the Committee

1. Top 10 to 20 creditors will receive a notice from the Office of the U.S. Trustee
   - Address on Top 20
   - Contact U.S. Trustee

2. Fill out request to serve on Committee
OFFICE OF THE UNITED STATES TRUSTEE
FOR THE NORTHERN DISTRICT OF TEXAS
1100 Commerce Street, Room 976
Dallas, Texas 75242
Tel. No. (214) 767-8967
Fax No. (214) 767-8971

QUESTIONNAIRE FOR OFFICIAL COMMITTEE OF UNSECURED CREDITORS

Please Type or Print Clearly.

I am willing to serve on a Committee of Unsecured Creditors. Yes ( ) No ( )

A. Unsecured Creditor's Name and Contact Information:

Name: ____________________________ Phone: ______________
Address: __________________________ Fax: ______________
____________________________________ E-mail: ______________

B. Counsel (If Any) for Creditor and Contact Information:

Name: ____________________________ Phone: ______________
Address: __________________________ Fax: ______________
____________________________________ E-mail: ______________

C. Amount of Unsecured Claim (U.S. $) __________________________

D. If your claim is against more than one debtor, list all debtors:
______________________________________________________________

E. Describe the nature of your claim(s), i.e., whether arising from goods or services provided; loans made; litigation, etc., including whether any portion is secured. If any portion of the claim(s) arise from litigation, please state the nature of the claim, the case number and jurisdiction (if applicable) and the status.
______________________________________________________________

______________________________________________________________

______________________________________________________________
3. Attend formation meeting
   - In person
   - Via telephone
   - Written proxy

4. Once selected
   - Select Committee chairperson
   - Select counsel
   - Agree to bylaws
   - ATTACK!

5. Committee member time commitment
Committee Impact

- **Biofuel Plant Case**
  - 180 million out of the money
  - Objected to cash collateral, financial advisor, bidding procedures
  - 2004 Examinations of the bank and the debtor
  - Emergency Hearings
  - Deal

- **Sale Case**
  - Sale
  - “Never, Never, Never, Never give up”
Committee Impact

- Kansas City Case
  - Attack first days
  - Attack cash collateral
  - Attack sale
  - Attack insiders

- FirstPlus Financial, Inc.
  - 300 boxes of documents
  - 25 2004 Examinations in 75 days
  - Reach deal
  - Obtain court approval of deal
Remember Committee Members Possess A Fiduciary Duty to **ALL** Unsecured Creditors

- Act in best interest of all unsecured creditors
- Competing Interests: Committee versus your own company
- Duty of diligence, loyalty, candor
- When in doubt, fully disclose and abstain
CONCLUSION

• Your case – Create an immediate presence
• Find leverage – Look under every rock
• Pick your battles – Get a deal approved
• Be a good fiduciary
I am sorry, what was that question?

Oh, you would like to know what my Creditors’ Committee experience is?

Well, if you insist...
Maximizing Distributions in Bankruptcies

- 20-Day Administrative Claim
- Postpetition Reclamation
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- New Proof of Claim Form
The Basics

Definition. A Proof of Claim is a written statement setting forth a creditor's claim against a debtor. A Proof of Claim is required to conform substantially to Official form No. 10.

Who May Execute. A Proof of Claim is required to be executed by the Creditor or the Creditor's authorized representative.

Claim Based on Writing. When a claim is based on a writing, the original or a duplicate shall be filed with the Proof of Claim.

Necessity for Filing. In order for an unsecured creditor's claims to be allowed it must file a Proof of Claim in accordance with the Bankruptcy Rules unless certain exceptions apply. However, the best rule is to always file a Proof of Claim.
The U.S. Supreme Court set forth bankruptcy rule changes, effective December 1, 2011, designed to prevent the presentation of claims for which there is little or no substantiation.
Primary Changes to Form 10
Proof of Claim

• Signature block now includes certification that information is “true and correct to the best of signer’s knowledge, information and reasonable belief.”

• Creditor must attach copies of documents that support a claim, not just a summary of the documents.

• Secured claim holder must disclose annual interest rate in effect at time bankruptcy case is filed, and whether rate is fixed or variable.
• The biggest of the POC form change is to emphasize the duty of accuracy imposed on a party filing a POC. The signature block on the new POC form requires that the claim be “true and correct to the best of the signer’s knowledge, information and reasonable belief.”
8. Signature:
Note the form is now signed under penalty of perjury. Intent is to emphasize the importance of accuracy in preparation and verification by the signer.

I declare under penalty of perjury that the information provided in this claim is true and correct to the best of my knowledge, information, and reasonable belief.

Penalty for presenting fraudulent claim: Fine of up to $500,000 or imprisonment for up to 5 years, or both. 18 U.S.C. §§ 152 and 3571.
• This requirement is one of the obvious fallouts from recent allegations that creditors were signing off on documents without taking steps to verify the accuracy of the facts asserted.

• The impact is that all POCs will require a person to review the information for accuracy and sign off on that assertion of accuracy.
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Debtor

Creditor

within
90 days

BANKRUPTCY

Post Confirmation-Trustee

preference lawsuit

Creditor
Preferential Transfers:  
(Why Credit Professionals Hate Them)

• A Customer owes you money.

• You do your job well, and your company gets paid most, but not all you are owed.

• The amount you were paid was for a legitimate, legally due and owing debt.

• Guess what?
Preferential Transfers:
(Why Credit Professionals Hate Them)

• A Customer owes you money.

• You do your job well, and your company gets paid.

• You collect a due and owing debt in a legal manner.

• Guess what? The Customer files bankruptcy, and you may have to return the *%#!@* money!

• Why did Congress allow this to happen??? Isn't the government here to help you??? (Answer: No, you're not G.M.)
Rationale Behind Bankruptcy Code § 547

“The purpose of the preference section is twofold. First, by permitting the trustee to avoid prebankruptcy transfers that occur within a short period before bankruptcy, creditors are discouraged from racing to the courthouse to dismember the debtor during the debtor's slide into bankruptcy. The protection thus afforded the debtor often enables the debtor to work its 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 his class is required to disgorge so that all may share equally. The operation of the preference section to deter the race of diligent' of creditors to dismember the debtor before bankruptcy furthers the second goal of the preference section, that of equality of distribution.”
Rationale Behind Bankruptcy Code § 547

• “Ideally” encourages creditors to continue dealing with troubled companies in the ordinary course of business.

• Deters debtors from selectively paying favored customers.

• Deters secret (unfiled) liens.

• Deters debtors from paying insiders and related entities.
TRUSTEE'S JOB:
Gather Assets For
Distribution To Creditors
Mechanics of a Preference Lawsuit

Assets include preference lawsuits.
Trustee

TRUSTEE (Debtor-in-Possession) HAS THE FIDUCIARY DUTY TO GATHER ASSETS UNDER BANKRUPTCY UMBRELLA
Mechanics of a Preference Lawsuit

Chapter 7:
• Trustee Pursues Recovery

Chapter 11:
• Debtor-in-possession, Creditors' Committee or Post-Confirmation Entity (such as Creditors' Trust) Pursues Recovery
IN RE: SIMRIDGE TECHNOLOGIES, LTD. Case No. 03-14371-FRM
Debtor. Chapter 7

MARSHA G. MILLIGAN, TRUSTEE, §
Plaintiff, §

v. §
PERFORMANCE POLYMERS, A §
DIVISION OF UNIVAR USA, INC., §
Defendant. §

Adv. Proceeding No. ____________

ORIGINAL COMPLAINT TO AVOID AND RECOVER TRANSFERS

TO THE HONORABLE JUDGE OF THE U.S. BANKRUPTCY COURT:

COMES NOW Marsha G. Milligan, Chapter 7 Trustee (the “Trustee”) in the above-styled case for the estate of SimRidge Technologies, Ltd., and files this Original Complaint to Avoid and Recover Transfers (the “Complaint”) against Performance Polymers, A Division of Univar USA, Inc. (the “Defendant” or “Univar”) and, in support thereof, would show as follows:

I. JURISDICTION AND VENUE


2. Venue lies in this district and this Court under 28 U.S.C. §§ 1408 and 1409.
Burden of Proof

**Plaintiff:** Has burden of proving 7 Preferential Transfer Elements (§ 547(b)).

**Defendant:** Has burden of proving Defenses, e.g. Ordinary Course and New Value (§ 547(c)).
Elements of Proof in a Preference Lawsuit

1. Transfer by the debtor;
2. Of an interest of the debtor’s property;
3. To or for the benefit of a creditor;
4. On account of an antecedent debt;
5. Made while the debtor is insolvent;
6. Made within 90 days before bankruptcy; and
7. Enables creditor to receive more than in Chapter 7.
Elements of Proof in a Preference Lawsuit

Trustee’s (Plaintiff’s) Burden of Proof:

1. & 2. *Any transfer of an Interest of the Debtor in Property;*

- Broadly defined “every mode, direct or indirect, absolute or conditional, voluntary or involuntary, disposing of or parting with property or an interest in property . . .”

- In other words, any action that removes property or an interest in property from the debtor and delivers it to another party is a “transfer.”

- Security interests, returned inventory, payment, options to purchase assets; execute a judgment; Anything that diminishes or depletes the debtor's estate.
Elements of Proof in a Preference Lawsuit
Trustee’s Burden

3. *To or for the benefit of a creditor;*
   - Creditor: Anyone with a “claim.” Broadly defined: contingent, disputed, not matured. . .

4. *For or on account of an antecedent debt owed by the debtor before such transfer was made;*
   - i.e. for invoices that are due or past due.
   - Payment on any outstanding invoices, whether they are due or not, is a payment on account of an antecedent debt.
   - Cash in advance payment for goods?
Elements of Proof in a Preference Lawsuit
Trustee’s Burden

5. *Made while the debtor was insolvent*;
   - financial condition such that the sum of the debtor's debts is greater than all of the debtor's property, at a *fair valuation*
   - Solvency is presumed during 90 days prior to Bankruptcy
   - Solvency presumption can be “burst”
   - Significantly alters the negotiation dynamics

6. *Made within 90 days before bankruptcy is filed (one year for insiders); and*
Elements of Proof in a Preference Lawsuit

Trustee’s Burden

7. That enables such creditor to receive more than such creditor would receive if –

   a) the case were a case under Chapter 7 of the Bankruptcy Code;

   b) the transfer had not been made; and

   c) such creditor received payment of such debt to the extent provided by the provisions of the Bankruptcy Code.

   - Hypothetical Chapter 7 test.

   - Practical affect: if secured creditor only value of collateral, this test is not satisfied
Elements of Proof in a Preference Lawsuit
Creditor’s Burden

1. Contemporaneous Exchange – Section 547(c)(1)

2. Ordinary Course of Business – Section 547(c)(2)

3. Enabling Loan Defense – Section 547(c)(3)

4. Transfer of Subsequent New Value – Section 547(c)(4)

5. Security Interests in Inventory or Receivables – Section 547(c)(5)
Elements of Proof in a Preference Lawsuit
Creditor’s Burden

1. Contemporaneous Exchange – Section 547(c)(1)
2. Ordinary Course of Business – Section 547(c)(2)
3. Enabling Loan Defense – Section 547(c)(3)
4. Transfer of Subsequent New Value – Section 547(c)(4)
5. Security Interests in Inventory or Receivables – Section 547(c)(5)
Contemporaneous Exchange

a. Intent for contemporaneous exchange by both debtor and creditor;

b. A contemporaneous exchange actually occurs; and

c. Creditor provides “real” new value.

(Examples: COD/inventory exchanges or re-mix)
Elements of Proof in a Preference Lawsuit
Creditor’s Burden

1. Contemporaneous Exchange – Section 547(c)(1)
2. Ordinary Course of Business – Section 547(c)(2)
3. Enabling Loan Defense – Section 547(c)(3)
   * Purchase Money Security Interest
4. Transfer of Subsequent New Value – Section 547(c)(4)
5. Security Interests in Inventory or Receivables – Section 547(c)(5)
Elements of Proof in a Preference Lawsuit

Creditor’s Burden

1. Contemporaneous Exchange – Section 547(c)(1)
2. Ordinary Course of Business – Section 547(c)(2)
3. Enabling Loan Defense – Section 547(c)(3)
4. Transfer of Subsequent New Value – Section 547(c)(4)
5. Security Interests in Inventory or Receivables – Section 547(c)(5)
Preference Attack: Ordinary Course of Business
Ordinary Course of Business Defenses

Ordinary course of business test requires that a transfer be in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee, and either:

1) Made in the ordinary course of business or financial affairs of the debtor and the transferee (the so-called “subjective” ordinary course test); or

2) Made according to ordinary business terms (the so-called “objective” ordinary course test).
Ordinary Course of Business Defenses

Ordinary course of business test requires that a transfer be in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the (i) **debtor** and the (ii) **transferee**, and either:

1) Made in the ordinary course of business or financial affairs of the debtor and the transferee (the so-called “subjective” ordinary course test); **or**

2) Made according to ordinary business terms (the so-called “objective” ordinary course test).
Defenses in a Preference Lawsuit

Ordinary Course of Business Defenses

Ordinary course of business test requires that a transfer be in payment of a debt \textit{incurred} by the \textit{debtor} in the ordinary course of business or financial affairs of the (i) \textit{debtor} and the (ii) \textit{transferee}, and either:

1) \textit{Made} in the ordinary course of business or financial affairs of the (iii) \textit{debtor} and the (iv) \textit{transferee} (the so-called “subjective” ordinary course test); \textbf{or}

2) Made according to ordinary business terms (the so-called “objective” ordinary course test).
Defenses in a Preference Lawsuit

Ordinary Course of Business Defenses

Ordinary course defense is essentially a new statute post-BAPCPA. This substantial change was accomplished by changing an 'and' to an 'or'.

What does this mean for creditors?

Two disjunctive, alternative defenses:

1. [OCB#1] Preferential payment was made in the ordinary course of the debtor's and the creditor's/defendant's business,

   -OR-

2. [OCB #2] Payment made in accordance with ordinary business terms.
Defenses in a Preference Lawsuit

New Ordinary Course of Business Defense

Ordinary course defense is essentially a new statute post-BAPCPA. This substantial change was accomplished by changing an 'and' to an 'or'.

What does this mean for creditors?

Two disjunctive, alternative defenses:

1. [OCB#1] Preferential payment was made in the ordinary course of the debtor's and the creditor's/defendant's business,

-OR-

2. [OCB #2] Payment made in accordance with ordinary business terms.
Defenses in a Preference Lawsuit

Subjective OCB Test [OCB #1]

Alleged preferential payment was made in the ordinary course of the debtor’s and the creditor’s/defendant’s business.

a. Consideration of quantifiable factors (Mathematical comparison of payment history before and during the preference period); and

b. Consideration of non-quantifiable factors (i.e., timing, amount, manner, collection efforts, change credit terms and circumstances of transfers).
Defenses in a Preference Lawsuit [OCB #1]

OCB #1- Key Cases

1. Courts typically consider factors such as (i) the prior course of dealing between the parties, (ii) the amount of payment, (iii) the timing of payments, (iv) circumstances surrounding the payments, (v) the existence of any unusual debt collection practices, and (vi) changes in the means of payment. *See*, e.g., *In re Ames Department Stores, Inc.*, 450 B.R. 24, 33 (Bankr. S.D.N.Y. 2011); and *In re 360 Networks (USA) Inc.*, *et al.*, 338 B.R. 194, 210 (Bankr. S.D.N.Y. 2005).

2. Late payments do not preclude a finding that the payment occurred during the ordinary course of business; in fact a pattern of late payments can establish an ordinary course between the parties. *In re American Home Mortgage Holdings, Inc.*, *et al.*, 476 B.R. 124.

3. Even a one-time transaction might be within the ordinary course of business if neither party did anything unusual with respect to the transfer made in payment of the underlying debt. *In re Forman Enterprises, Inc.*, 293 B.R. 848 (Bankr. W.D. Pa. 2003)
Defenses in a Preference Lawsuit [OCB #1]

Ex: Debtor files bankruptcy on May 11, 2013

Pre-preference

“Look Back” Period

Preference Period

Beginning of Vendor relationship

90 days

02/10/13 05/11/13

(Petition Date)
# Ordinary Course of Business Worksheet

15 Month History Before Petition Date [OCB #1]

<table>
<thead>
<tr>
<th>Invoice Number</th>
<th>Invoice Date</th>
<th>Invoice Amount</th>
<th>Check/Wire No.</th>
<th>Check/Wire Date</th>
<th>Payment Amount</th>
<th>Payment Due Date</th>
<th>Payment Receipt Date</th>
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</thead>
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<td>03/03/13</td>
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<td>48</td>
</tr>
</tbody>
</table>

**HISTORICAL DATA**

**PREFERENCE PERIOD DATA**
## Ordinary Course of Business Worksheet

### 12 Month History Before Petition Date [OCB #1]

<table>
<thead>
<tr>
<th>Date</th>
<th>Amount</th>
<th>Date</th>
<th>Amount</th>
<th>Date</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
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<td>05/01/12</td>
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<td>07/01/12</td>
<td>07/21/12</td>
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<tr>
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<td>07/16/12</td>
<td>$40,000.00</td>
<td>07/31/12</td>
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<td>$45,000.00</td>
<td>10/01/12</td>
<td>10/19/12</td>
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<tr>
<td>10/01/12</td>
<td>$30,000.00</td>
<td>11/23/12</td>
<td>$30,000.00</td>
<td>10/31/12</td>
<td>11/27/12</td>
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<tr>
<td>12/01/12</td>
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<td>$13,000.00</td>
<td>12/31/12</td>
<td>01/20/13</td>
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<tr>
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<td>02/12/13</td>
<td>$18,000.00</td>
<td>01/31/13</td>
<td>02/16/13</td>
</tr>
<tr>
<td>02/01/13</td>
<td>$20,000.00</td>
<td>03/17/13</td>
<td>$20,000.00</td>
<td>03/03/13</td>
<td>03/21/13</td>
</tr>
</tbody>
</table>

Mean: 39  
Median: 47  
Mode: 48  
Std. Dev.: 15  
Minimum: 10  
Maximum: 57
### Ordinary Course of Business Worksheet

#### Preference Period [OCB #1]

<table>
<thead>
<tr>
<th>Invoice Number</th>
<th>Invoice Date</th>
<th>Invoice Amount</th>
<th>Check/Wire No.</th>
<th>Check/Wire Date</th>
<th>Payment Amount</th>
<th>Payment Due Date</th>
<th>Payment Receipt Date</th>
<th>Invoice Date to Payment Receipt Date (Days)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1013</td>
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<td>$21,000.00</td>
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<td>05/31/13</td>
<td>06/13/13</td>
<td>43</td>
</tr>
</tbody>
</table>

#### Preference Period Data

- **Mean**: 59
- **Median**: 50
- **Mode**: N/A
- **Minimum**: 43
- **Maximum**: 84
Focus is on average number of days between invoice date and date check is received (or between due date and check receipt date).
Defenses in a Preference Lawsuit [OCB #1]

Average time to pay during Preference Period: 59 days
Average time to pay 12 month historically: 39 days

Which data set works best for you?

A. 12 month historical average: __39 days__
B. 9 month historical average: __45 days__
C. 6 month historical average: __50 days__
Defenses in a Preference Lawsuit [OCB #1]

What is within “Ordinary Course?”

A. Within 10 days of average? 15 days?
B. Consistent with prior practices?
C. Inside the historical range?
D. Well established payment practices?
E. Look at actual payment history, not contract terms.
F. Late payments can be ordinary course of business!
G. First time/irregular payments can be ordinary course of business!
Get creative:

- Remove/include extraneous data points that skew averages
- Different historical analysis: 9 months; 18 months; 24 months
- Median, mode
- Standard deviation
- Frequency analysis
- Seasonality charting
- Special promotions effects
Defenses in a Preference Lawsuit [OCB #1]

Factors most frequently considered by the courts when evaluating whether a transfer took place in the “ordinary course of business” [OCB #1] include:

– timing of the transfer
– amount of the transfer
– manner of the transfer
– circumstances of the transfer
Defenses in a Preference Lawsuit

New Ordinary Course of Business Defense

Ordinary course defense is essentially a new statute post-BAPCPA. This substantial change was accomplished by changing an 'and' to an 'or'.

What does this mean for creditors?

Two disjunctive, alternative defenses:

1. [OCB#1] Preferential payment was made in the ordinary course of the debtor's and the creditor's/defendant's business,

   -OR-

2. [OCB #2] Payment made in accordance with ordinary business terms.
Defenses in a Preference Lawsuit

Objective OCB Test [OCB #2]

Alleged preferential payment was made in accordance with ordinary business terms.

Courts generally interpret the phrase “ordinary business terms” to mean the range of terms that encompasses the practices in which firm similar in some general way to the creditor in question engage, and that only dealings so idiosyncratic, aberrational, or unusual as to fall outside that broad range should be deemed extraordinary. See, In re American Camshaft Specialties, Inc., 444 B.R. 347, 365 (Bankr. E.D. Mich. 2011).
Defenses in a Preference Lawsuit

Objective OCB Test [OCB #2]

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New Ordinary Course of Business Defense: 
**Ordinary Business Terms** [OCB #2] New, Separate Defense

How courts have interpreted this change:

- “Ordinary business terms” is now a separate defense
- The required link between the 'ordinary course of business' component and the 'ordinary business terms' component has been removed by BAPCPA
- Industry standards are now applied to the factual circumstances of the transfer to determine “ordinary business terms”

Q: What is the relevant industry from which to draw the industry standard for challenged credit arrangements?

A: Courts look at credit practices between suppliers to whom a debtor might reasonably turn for its inventory and companies with whom the debtor competes (i.e., credit practices between your competitors and the debtor's competitors).
Note: The more cemented (as measured by its duration) the pre-insolvency relationship between the debtor and the creditor, the more the creditor will be allowed to vary its credit terms from the industry norm, yet remain within the safe harbor section of section 547(c)(2).
Defenses in a Preference Lawsuit [OCB #2]

Retain an expert –

• Recently retired credit professional
• Head of credit organization
• Service will do report for $10,000
• Puts Plaintiff on notice—not your average Preference Defendant!
• Almost anyone with experience can be an expert, for example...
Preference Attack:
New Value Defense
Defenses in a Preference Lawsuit

Subsequent New Value Exception

Protects transfers to or for the benefit of a creditor, such that after the transfer creditor gave new value to or for the benefit of debtor, and

a. New value not secured by otherwise unavoidable security interest; and

b. On account of the new value, debtor did not make an otherwise unavoidable transfer to or for the benefit of such creditor.
Defenses in a Preference Lawsuit

New Value Exception

After alleged preferential transfer, creditor:

a. Provides unsecured new value, including
   – New credit
   – Goods shipped
   – Services provided
   – Liens released

b. New value can’t be paid with unavoidable payment (no double dipping)

c. Rationale: May prevent bankruptcy, rewards creditors dealing with financially troubled company
Defenses in a Preference Lawsuit

Policy Considerations Supporting New Value Exception

1. Without the exception, a creditor who extends credit to the debtor, perhaps in implicit reliance on prior payments, would merely be increasing his bankruptcy loss.

2. Limited protection provided by the subsequent advance rule encourages creditors to continue their revolving credit arrangements with financially troubled debtors, and potentially helps the debtor avoid bankruptcy altogether.
### Invoice Worksheet

<table>
<thead>
<tr>
<th>Invoice Number</th>
<th>Invoice Date</th>
<th>Invoice Amount</th>
<th>Check No.</th>
<th>Check Date</th>
<th>Check Amount</th>
<th>Check Receipt Date</th>
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</tbody>
</table>

**NOTE TO PREPARER:**

This worksheet is intended to show the chronology of payments received and shipments made during the Preference Period. Each individual payment (by check, wire or otherwise) received during the Preference Period, and each shipment made during the Preference Period, should be listed chronologically. The information should be forwarded to us by e-mail in Microsoft Excel format, if possible.
Defenses in a Preference Lawsuit

New Value Analysis
(90 days prior to bankruptcy filing only)

<table>
<thead>
<tr>
<th>Invoice Number</th>
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<th>Check Date</th>
<th>Check Amount</th>
<th>Check Receipt Date</th>
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<td>$42,092.09</td>
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</tbody>
</table>
Creditor Prevention of Preference Lawsuits
Creditor Prevention of Preference Lawsuits

As with other things in life, preferential transfers will happen. Nevertheless, a credit professional can take steps to avoid the characterization of a payment as “preferential.” The following are recommendations in your relationships with customers/potential-debtors that might help you avoid being a victim of a preference lawsuit:
Creditor Prevention of Preference Lawsuits

**Third Party Payment**

A payment is not preferential if: (i) it is made from the assets of a third party, and (ii) it does not diminish the assets remaining in the debtor's estate. Ideally, the debtor should have no part in such a transaction. If the debtor simply borrows the money from a third party to make the payment, there is a danger that the court will still construe the payment as having been made by the debtor to the creditor, rendering it an avoidable preference. On the other hand, if a third party makes the payment directly to the creditor, the preferential transfer issue can likely be avoided.
Creditor Prevention of Preference Lawsuits

Third Party Guaranty

Although collection from a non-debtor guarantor may sometimes be postponed by the debtor's bankruptcy filing, bankruptcy discharges only obligations of the debtor, not those of a non-debtor guarantor. Thus, by obtaining the guaranty of a solvent third party, a creditor can often shift the risk of the debtor's later bankruptcy to that guarantor.
Creditor Prevention of Preference Lawsuits

Preference Indemnities

A solvent third party who will not willingly guarantee the payment of a debt may, nevertheless, be willing to guaranty or indemnify against preferential transfer avoidance in the event the account debtor enters bankruptcy.
Creditor Prevention of Preference Lawsuits

Obtain a purchase money security interest

If you are supplying inventory for the debtor, demand a purchase money security interest in the goods sold to the debtor. This requires a UCC filing, and should be accomplished prior to the 90-day preference period, or the security interest risks avoidance as a preference. If the purchase money security interest is granted during the preference period and enables the debtor to acquire product that is the subject of the security interest, make sure that the funds received were used to acquire the product, and that the UCC is filed on or before 30 days after the debtor acquires possession of the product.
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The trust or bailment exception

To be preferential, a transfer must be made from “an interest in the property of the debtor.” In some circumstances, it may be possible to structure a settlement as a return of property of the creditor that was being held by the debtor in express or constructive trust. If the property used to make the payment can be traced to the creditor as the original source, the payment may survive attack as a preference.
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Payment in property

The return or other transfer of property in payment of a debt might constitute an avoidable preference. The principal danger here is that the transfer expressly or implicitly overvalues the property returned, thereby creating preference liability in excess of the value the creditor actually received. So, for example, when a vendor accepts returned goods from a customer in the shadow of the customer's bankruptcy, a settlement document or credit memo should expressly state the value of the goods returned to the vendor. The vendor might otherwise be held liable in a preference action for the original purchase price of the goods.
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Change to a “cash in advance” or COD basis

If you find that an account debtor is getting behind on its payments, then decisively change payment requirements to a “cash in advance” or COD basis. Insist on cash, cashier's check, certified check or wire transfer, and demand payment based upon the immediate same day exchange of new inventory that the debtor receives, or make the transfer COD and accept no company checks – only cash, cashier's check or money orders.
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Promptly cash all checks received

If a check is honored prior to the preference period, it is not a preferential transfer. Also, the earlier one knows of the debtor's financial problems, the better.
Establish uniform collection procedures

Establish a uniform set of procedures for the collection of debts and apply it evenly to all your customers. Customizing collection practices to an individual account debtor may satisfy the needs of the moment, but runs the risk of any payments received being found to be outside the ordinary course of business, and therefore preferential.
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Demand receipt of regular, timely financial statements

When you are dealing with a slow-paying debtor, ask that the debtor provide regular, timely financial statements showing the debtor's assets and liabilities. If a balance sheet shows that the debtor is a solvent corporation, then the creditor can assert the debtor's solvency in the event of any subsequent preference avoidance action. You should ask for financial statements from a slow-paying company every month or so, and no less frequently than quarterly.
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Make the debtor prove its prima facie case

Do not return the alleged preferential payment to the debtor, even if you feel that the debtor is correct in his demand. Bankrupt debtors and bankruptcy trustees will often settle for a smaller percentage of the preferential payment. You could save yourself some money just by making the debtor go through the hoops of providing you with evidence of a prima facie case.
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Workout of troubled debt with Preference Prevention in mind

- Solvency representation.
- Payment from third party.
- No release until 91 days after receipt of payment.
- Preference indemnity.
- Does workout destroy ordinary course of business defense?
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Certain Cases – Consider Structured Dismissals

- New, more creative solution to prevent preferences entirely
- Example: § 363 Sales of Substantially all Assets
- US Trustee and most judges are not fans
- Examples:
  - SDA
  - Al Liebers
KRCL Preference
KRCL Preference Game Plan

For MEMA Members

Problems:
1. Exorbitant legal fees add insult to injury
2. Necessary data accumulation and organization
3. Need to negotiate from strength
KRCL Preference Solutions

• Cost-effectively obtain information
  – Questionnaire
  – OCB spreadsheet
  – New Value spreadsheet
• Keeps lawyers out of data accumulation
• Handle preference for $275 per hour until litigation starts

[Goal: Keep legal fees to a minimum]
KRCL Preference Solutions

After obtaining and analyzing data – Draft detailed settlement letter

- OCB #1 and #2
- New Value
- Solvency
- Expert (OCB #2)
- We insert the best cases
KRCL Preference Solutions

• If negotiations are unsuccessful, then litigation at normal hourly rates (fairly rare, but you control it)

• Under $25,000 – oversee pursuant to the MEMA retainer for free (plus expenses) through settlement letter

• Applies to MEMA members retaining KRCL exclusively for all preferences nationwide