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1

What the Preference Laws Are About and Why They Should Be Amended.



2

What is the problem that the preference laws try to solve?



3

Welcome to the bankruptcy party!



4

This is a special party. Everyone is invited but some people get their early.



5



6

The host may say, "Please put the pieces back so that everyone will get an equal slice."



7

Should everyone have to return the slices?

Did someone show up early on purpose?

What if no pie left at all?



8

What is a preference clawback?



9

Not defined in the Bankruptcy Code. Only what can be "avoided" or not.



10

Sec. 547 (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.



11

Sec. 547 (c) : The trustee **may not avoid** under this section a transfer—

- (1) to the extent that such transfer was—
 - (A) intended by the debtor and the creditor to or for whose benefit such transfer was made to be a contemporaneous exchange for new value given to the debtor; and
 - (B) in fact a substantially contemporaneous exchange;



12

Sec. 547 (c) : The trustee **may not avoid** under this section a transfer—

(2) to the extent that such transfer was 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 such transfer was—

(A) made in the ordinary course of business or financial affairs of the debtor and the transferee; or

(B) made according to ordinary business terms;



13

Sec. 547 (c) : The trustee **may not avoid** under this section a transfer—

(4) to or for the benefit of a creditor, to the extent that, after such transfer, such creditor gave new value to or for the benefit of the debtor—

(A) not secured by an otherwise unavoidable security interest; and

(B) on account of which new value the debtor did not make an otherwise unavoidable transfer to or for the benefit of such creditor



14

Any Full Payment to a Creditor When the Debtor is Insolvent and Followed by a Bankruptcy.



15

The rationales for the preference clawback laws.



16

Rationale 1:
Equality of distribution during insolvency.



17

Rationale 2:
Discourage creditors from being aggressive when a company is in trouble and thereby avoiding bankruptcy, if possible.



18



19

Rationale 3:
Encourage creditors to do business with troubled companies.



20

Rationale 4:
Preference laws create more fairness and more transparency.

Creditors know that the trustee will sue for preference payments and that encourages trade.



21

Rationale 5:
Prevent diminution of the estate.



22

Rationale 6:
Leave undisturbed the ordinary course dealings.



23

Problems in practical application of a well-meaning law.



24

Findings - Business History of the Parties

	Pre - Preference Period (A year prior to pref. period)	Preference Period (90-day period prior to the bankruptcy filing)
Average Days to Pay	45.3 days	28 days
Payment Pattern	Late Payments	Quicker Payment as a result of credit pressure
Collection Pressure	No	Yes
Payment Term	Net 30	Weekly Payment
Payment Plan	Debtor was once placed on a accelerated payment plan for three months, but it was not recurrent negotiations of credit terms between parties throughout the business relationship	Prudential's knowledge of debtor's deteriorating financial condition prompted second and then, amended payment plan which resulted in quick transfers by debtors during the preference period

31

Reasoning and Court's Decision

Transactions Not Ordinary Between the Parties.

•Creditor insisted on a quicker payment schedule as it became aware of the debtor's financial troubles.

•Prudential was getting much more than other creditors who did not apply pressure and ended up with unpaid bankruptcy claims. This resulted in unequal distribution, which preference law aims to prevent.

•Credit terms between the parties also changed significantly during the preference period after the creditor learned of the debtor's deteriorating financial condition.

•Under pressure, the debtor was making big payments to one creditor and not to other creditors, thus unequal distribution.

•Judgment was entered in favor of trustee and Prudential was asked to return the transfers received during the preference period.

•Similar situated creditors should receive similar recoveries.

32

Changes property rights retroactively and with no notice—do what you want to not your decision.

33

This case law shows how a court treated a transfer of security interest in property by the debtor to its creditor in order to secure a line of credit with the creditor, as being a preferential transfer despite the fact that the actual transaction took place outside the 90-day preference period.

34

Kaliner v. Willow Grove Bank (In re ATS Prods. Corp.),

Nos. 01-13220F, 01-0273,

2003 Bankr. LEXIS 2354 (U.S. Bankr. E.D. Pa. June 5, 2003)

35

Facts:

- The debtor company and the defendant bank entered into a loan, security and suretyship agreement which provided the debtor with a line of credit from the defendant bank not to exceed \$5,000,000.00.
- Prior to the 90 day preference period, the creditor issued irrevocable letters of credit secured by the debtor's receivables and inventory in furtherance of the parties' agreement.
- The defendant perfected its security interest within the preference period.
- The trustee sought to avoid as preferential the defendant's perfection of the security interest in a bankruptcy debtor's receivables and inventory.

36

Arguments:

- The trustee argued that because the transfer of the security interest took place during the preference period, it was a preferential transfer.
- The defendant contended that the amount by which the defendant was under-secured increased during the preference period, that the defendant did not improve its position by perfection of the security interest, and that thus the security interest was not avoidable as a preferential transfer.



37

Court's ruling:

- The bankruptcy court held that the security interest was avoidable since the defendant did not advance additional funds to the debtor during the preference period, and instead honored the letters of credit, which were issued and became irrevocable outside the preference period.
- Thus, the perfection of the defendant's security interest reduced the defendant's under-secured status and therefore improved its position during the period between the beginning of the preference period and the debtor's bankruptcy petition, and other unsecured creditors would be prejudiced by this improvement in the creditor's position.



38

Changes contract law rights retroactively and with no notice—kept promises to broken promises.



39

This case law shows how the court held a mutual agreement between the debtor and the creditor to change the terms of their contract from a “shipping contract” to a “destination contract” in furtherance of their business as a deviation from the ordinary course of business between the parties.

As per the court, this deviation caused the alleged transfers to be considered as preferential.



40

Rijken v. Entec Distrib., LLC (In re Felt Mfg. Co.),

2009 BNH 26



41

Facts:

- The debtor manufactured nonwoven fabrics from polyester resins which it purchased from the creditor.
- Due to concerns about the debtor's financial circumstances, the parties altered their contractual arrangement from a shipping contract to a destination contract whereby the creditor would release resin to the debtor only upon payment from the debtor of prior invoices to avoid exceeding the debtor's credit limit.
- During the preference period, the debtor paid the creditor an amount of \$ 519,346.55 for the products supplied by the creditor.
- The trustee sought to recover this amount as preferential transfer.



42

Arguments:

- The Trustee asserted that the alleged transfers met all the elements of a preferential transfer.
- The creditor argued that there was no significant change in the timing of payments made in the preference period as compared to those made during the preference period.
- The creditor asserted that most of the preference period payments were made within the range established during the base period. The creditor also asserted that there was some deviation in the timing of some of the preference period payments because both parties agreed to change in shipping and credit terms as per their agreement.
- The creditor also argued that it supplied new value to the debtor during the preference period when it released the resin to the debtor.



43

Court's ruling:

- The bankruptcy court first held that the creditor failed to show that the preferential transfers from the debtor were made in the ordinary course of both the creditor's business and the debtor's business.
- Certain of the payments were made outside the ordinary period in which the debtor paid the creditor's invoices, and the debtor and the creditor deviated from their ordinary practices under the new agreement which provided payment and shipping terms designed to protect the creditor.
- However, under the new agreement the creditor retained title to the resin delivered to the debtor until the debtor paid prior invoices, and thus the creditor gave new value subsequent to certain of the payments on the dates when the creditor released the resin to the debtor.
- Judgment was entered in favor of the trustee to the extent that only a portion of the preferential transfers was avoided.



44

Reverses law with no notice.



45

Why can there never be notice?



46

- Misinformation by the debtor.
- Change in circumstance by the debtor.



47

Changing the law with no notice is fundamentally unfair.



48



49

Rationale 1:
Equality of distribution during insolvency.



50



51

First, unsecured creditors usually don't get the money that is recovered and it is not distributed to other unsecured creditors.



52

There is no law which requires that the money received from avoidance actions needs to be segregated and paid to unsecured creditors. In fact, the opposite usually happens.

Usually, the funds go to secured creditors or administrative expenses (that's right the lawyer suing you).



53

The amount of money available to unsecured creditors is actually diminished by preference actions.

Why?



54

Because a creditor who is forced to return money that was transferred preferentially has a claim for that amount of money against the amount of funds left for unsecured creditors.



55

So, not only do unsecured creditors rarely receive the money that is avoided, the amount of money in the unsecured creditors' fund needs to be divided by yet another creditor.



56

More people eating. Same size pie. The missing pie slices are not returned.



57



58

The amount of money available to 4 unsecured creditors with each having \$25k and estate of \$100k	\$25k
New money brought into the estate by a creditor who previously had no claim/new money brought into the estate by the avoidance action.	\$0.00
New unsecured claim as a result of the successful avoidance action.	\$25k
New amount available for distribution to each creditor	\$20k



59

.....so a law designed to help unsecured creditors usually hurts them.



60

Another reason “equality of distribution”
rational does not make sense.

Most, if not all, creditors are paid in the 90-day
period.



61

If all or most creditors are paid, how can any
one creditor be preferred?

Can all creditors be preferred?



62

Reason no. 3 why the “equality of distribution”
argument does not make sense.



63

Not only do the preference laws result in not
making things more equal for unsecured
creditors, they actually create a NEW class of
preferred creditors.



64

Early to the party and they keep the big slices.

This new class of creditors get 100% payment
when the debtor is insolvent while unsecureds
are forced to return ALL payments.



65

“Contemporaneous” recipients, COD creditors,
pre- 90 day and secured creditors with NEW
liens on after acquired property get fully paid.



66

Why exempt so called contemporaneous exchanges?



67

If it's a simultaneous exchange of cash for goods, then in theory that debt is really not created.

The purpose of the preference law is to make sure that creditors are treated equally.



68

If a vendor is paid immediately, that vendor is not a creditor because he/she is not owed money.



69



70

Silverman Consulting, Inc. v. Canfor Wood Prods. Mktg.
(In re Payless Cashways, Inc.)

306 B.R. 243, Bankr. L. Rep. (CCH) P80,057, 51 Collier Bankr. Cas. 2d (MB) 1213, 42 Bankr. Ct. Dec. 180, 53 U.C.C. Rep. Serv. 2d (Callaghan) 518 (B.A.P. 8th Cir. 2004)



71

Facts:

- The creditor shipped lumber to the debtor.
- The goods were shipped via trucks and rail.
- The parties had agreed that shipments would only be made if the debtor paid by electronic funds transfer (EFT).
- All of the payments were made within 15 days of the shipment date for rail shipments and within 6 days of the shipment date for truck shipments.
- At least as to eight of the payments, the creditor received payment prior to delivery.
- The parties intended that the debtor would not obtain possession until after payment.



72

Arguments:

- Trustee - any transaction that was evidenced by an invoice was an antecedent debt.
- Creditor - By allowing the goods to be delivered to the debtor, it made a contemporaneous exchange for a new value.



73

Court's ruling:

The Court held that the payments were contemporaneous exchanges for new value because of the following reasons:

1. The creditor treated each shipment as a receivable on the date of shipment, and the debtor treated it as a payable on that same date.
2. The estate was not diminished, as shipments were to be diverted if payment was not received.
3. In any event, payments were made within 15 days of shipment which was substantially contemporaneous.

On appeal, the BAP for the 8th Circuit affirmed Bankruptcy Court's ruling.



74

Don't diminish the estate. But neither do any legitimate creditors. Actually hurt debtor by not extending terms and using leverage.

Arbitrary.



75

Why exempt transfers over 90 days when the debtor is insolvent?

Arbitrary.



76

Barnhill v. Johnson

503 U.S. 393, 394 (U.S. 1992)

(Supreme Court of the United States, March 25, 1992)



77

Facts:

- The Debtors made payment on a debt by delivering a check to the Creditor.
- Check delivered to Creditor on: November 18, 1985
- Check was dated: November 19, 1985
- Check was honored: November 20, 1985
- Debtors' bankruptcy was filed on: February 18, 1986 (90th day from check honor date)

Arguments:

- Defendant contended that the "transfer" was made on the date the check was delivered. Therefore, it was made out of preference period.



78

Supreme Court's ruling:

•A check is simply an order to the drawee bank to pay the sum stated on demand. If the check is honored, the debtor's obligation is discharged, but if it is not honored, a cause of action against the debtor accrues to the check recipient "upon demand following dishonor."

•Honoring the check left the debtor in the position that it would have occupied had it withdrawn cash from its account and handed it over to Barnhill.

•The rule of honor is consistent with § 547(e)(2)(A), which provides that a transfer occurs at the time it "takes effect between the transferor and the transferee," particularly since the debtor here retained the ability to stop payment on the check until the very last.



79

Delay in perfection of a lien may affect the timing of "transfer"



80

French v. State Farm Mut. Auto. Ins. Co. (In re LaRotonda)

436 B.R. 491, 2010 Bankr. LEXIS 3241 (Bankr. N.D. Ohio 2010)



81

Arguments:

•Defendant argued that it became a secured creditor on the day it obtained lien i.e. in the year 2006. Therefore, the transfer was outside the preference period.

•Trustee argued that the lien was perfected during the preference period. Here the transfer was preferential.

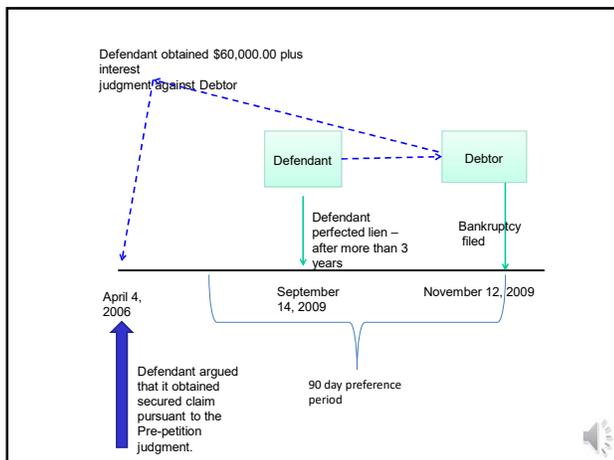
Court's ruling:

•Pre-petition lien judgment standing alone does not give rise to a secured interest. Defendant needed to perfect the lien as per State law.

•As lien was perfected during the preference period, it was a valid preferential transfer avoidable by the Plaintiff.



82



83

Why exempt new liens placed on property during the preference period?

Arbitrary.



84

Rationale 2:
Discourage creditors from being aggressive when a company is in trouble and thereby avoiding bankruptcy, if possible.



85

Menotte v. Oxyde Chemicals, Inc. (In re JSL Chem. Corp.)

424 B.R. 573, 2010 Bankr. LEXIS 443, 74 A.L.R. Fed. 2d 671 (Bankr. S.D. Fla. 2010)



86

Facts:

- Plaintiff sought to recover an amount of \$ 79,343.35 made by the debtor to defendant creditor, as payment for chemicals the creditor had supplied to the debtor.
- Out of the creditor's 30 invoices to the debtor, 27 were paid during the base period, one was paid during the preference period, and two remained unpaid as of the petition date.
- The agreed payment terms were net 30 days, but the debtor was a habitual late payer.



87

Arguments:

- The creditor asserted a defense based on the ordinary course of business.
- The plaintiff argued that payments was not made in the ordinary course but was rather made as a result of collection pressure by the creditor.



88

Issue:

- Are payments received as a result of unusual collection pressure on the debtor out of the ordinary course of business?



89

Court's ruling:

- The payment to the creditor was made in response to unusual collection efforts.
- The debtor had been notified that it was placed on credit hold by the creditor.
- The payment was held as avoidable preferential transfer.



90

Conclusion:

- Payments received as a result of unusual collection activity such as putting the debtor on a credit hold, may be out of the ordinary course of business. Such payments may be held as preferential payments.



91

The preference laws deter aggressive creditors from dismantling a debtor. Correct?



92

Unfortunately, no.



93

No one knows when a bankruptcy will be filed. So, no creditor knows whether it could be subject to a preference. So it makes no sense not to try to collect aggressively.



94

Bird in the hand is always better.



95

Rationale 3:
Helps troubled companies by encouraging business with troubled companies.



96

Playing field is more even in theory.

Truth is laws actually discourage vendors from doing business with a troubled, pre-bankruptcy company.



97

Actually discourage and punish workouts and extended terms.



98

Consistency between a historical period and the preference period is basis of ordinary course defense. Any variance is punished as destroying the exemption.



99

Extended terms that result in much later payments during the preference period are punished.



100

This case law shows how the court treated a creditor's good deed to extend credit terms to help a financially troubled debtor by deferring rent payments for about a year, as being a substantial deviation from the ordinary course of business between the parties.



101

*Montoya v. Battaglia (In re Weber),
Nos. 7-10-10058 JA, 10-1056,
2011 Bankr. LEXIS 2606 (U.S. Bankr. D.N.M. July 5, 2011)*



102

Facts:

- Defendant Denise Battaglia provided debtor Janet Marie Weber a place to live when Weber's home burned down and agreed to defer payment of rent for nearly a year until the debtor received proceeds from her insurance policy compensating for the loss.
- On receiving the insurance, Weber paid \$8,000 to Battaglia and filed for bankruptcy the following day.
- Trustee Philip J. Montoya sought to recover that amount as preferential transfer.



103

Arguments:

- Trustee Montoya stated that Battaglia received full payment on the claim and thus received more than what she would have received as an unsecured creditor, had the transfer not taken place.
- Defendant Battaglia argued that as the transaction was a first time transaction, it was protected under the ordinary course defense.



104

Court's ruling:

- The transfer was not made in the ordinary course as Battaglia was not in the business of renting out rooms or making similar extensions of credit, and the agreement between the parties occurred under the extraordinary circumstance of Weber losing her home to fire.
- Thus, granting trustee's motion for summary judgment, the court held that the amount was avoidable as preference.



105

Super short terms or COD terms or prepayment terms—Encouraged and Exempted.



106

This case law shows how the creditor's demand for prepayments before it performed majority of the work for the financially troubled debtor was encouraged by the court by holding that the prepayments made to the creditor were not preferential.



107

DOTS, LLC v. Capstone Media (In re DOTS, LLC)

533 B.R. 432, 2015 Bankr. LEXIS 2386, 61 Bankr. Ct. Dec. 86 (Bankr. D.N.J. 2015)



108

Facts:

- The defendant, Capstone Media was a small company that provided market research, media planning, media buying, promotional services, radio advertising, and social media series to the debtor, a fashion clothing retailer.
- In light of the terms of a master services agreement and statements of work (SOWs), it was apparent that a defendant would not carry out services on behalf of debtors until such services had pre-planned approval and were paid in advance.
- Therefore, the defendant was not entitled to compensation until the agreed upon services under each SOW were performed.
- During the preference period, the defendant received certain payments from the debtor. The plaintiff debtor sought to recover these payments as preference payments.



109

Arguments:

- Among other defenses to the preference claim, the defendant argued that the alleged preference payments were prepayments and were therefore not made for or on account of antecedent debt.



110

Court's decision:

- The court noted that the debt arose when debtors received the services and were then legally obligated to pay, not when the creditor chose to invoice debtors.
- As it was evident from the course of dealings between the parties that the majority of work would only be performed by the creditor upon prepayment by debtors, the transfers at issue were not tendered on account of antecedent debts as required by 11 U.S.C.S. § 547(b)(2) and thus, were not avoidable preferential transfers.
- The court granted summary judgment in favor of the creditor.



111

So the preference laws reward creditors with leverage (COD) and who hurt the debtor by refusing terms and hurt the creditors who help the debtor by extending terms (work outs).



112

Rationale 4:

Preference laws create more fairness and more transparency.

Creditors know that the trustee will sue for preference payments and that encourages trade.



113

Actually a lot is kept secret from unsecured creditors and the information is used against them.



114

- Not sued until well after terms extended to a post-petition debtor.
- Encouraging workouts that defeat the ordinary course defense.
- Where does the money go?



115

- Case settlements are often secret.
- Don't tell vendors they will be sued and accept goods anyway.



116

Rationale 5:
Prevent diminution of the estate.



117

Does not prevent diminishment of the estate.
Actually causes diminishment of the estate.



118

- Transaction as a whole.
- Goods and services sold at a profit.
- Estate is augmented by the transaction.



119

- Creditors obtain a windfall since they retain the goods and the profit.
- Discourages business with troubled companies, so less profit.



120

Maybe Nothing is Better. Introduction to the Triple Whammy.



121

First whammy:

Non-payment by the debtor prior to the bankruptcy.



122

Second whammy:

Clawback of payments for goods or services.



123

Third whammy:

Depressed industry.



124

But its just wrong for some creditors to get sweetheart deals or be preferred. Correct?

Not always.



125

- It makes sense to prefer some vendors sometimes.
- Sometimes good consideration is given for preference.



126

- The manager's judgment vs. the court's judgment on how to run a business.
- Making decisions so that the business stays in business and keeps employees.



127

What is the real issue messing up our preference laws?



128

No Intent is Required

Neither the intent nor motive of the parties is relevant in consideration of an alleged preference under 11 U.S.C.S. § 547(b). It is the effect of the transaction, rather than the debtor or creditor's intent, that is controlling. Therefore, what the parties might have intended to accomplish is immaterial; the effect of what was done is controlling



129

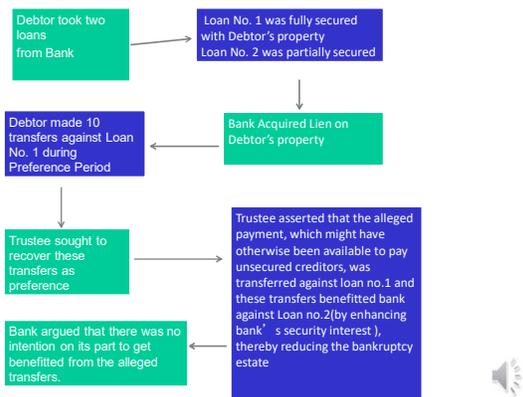
Gladstone v. Bank of Am., N.A. (In re Vassau)

499 B.R. 864 (Bankr. S.D. Cal. 2013)



130

Background of the Case



131



COURT'S CONCLUSIONS

• **Intent of the parties is irrelevant to the preference analysis**

• What the parties **might have intended is immaterial.**

• While the alleged payments may not have been made by the debtors **with the intent of benefiting** the bank towards partially secured loan, the court held that the transfer actually benefitted the creditor and hence the alleged payments are avoidable as preference.



132

The number one problem is that we sue defendants who have no bad intent.



133

Basic Truth--Any transfer to a creditor when the debtor is insolvent followed by a bankruptcy is preferential.



134

The argument for exempting all accidental unintentional preferences.



135

Accidental bigger slices and lottery winnings are not morally wrong.



136

The unfairness of a conscious scheme to get a bigger slice.



137

- Host intentionally favors certain early guests.
- Guest intentionally schemes for a bigger slice.



138

Everyone gets a preference. Fight bad actors, not preferences.



139

Bad actors have notice by definition. Accidental preferences don't.



140

Accidental preference recipients do not game system since no intention. Bad actors are flout the laws.



141

Benefits of Requiring Bad Intent—

- No notice problem—bk is known.
- Law is fairer—focus is on bad conduct
- Intentional gaming punished not innocent oc business.

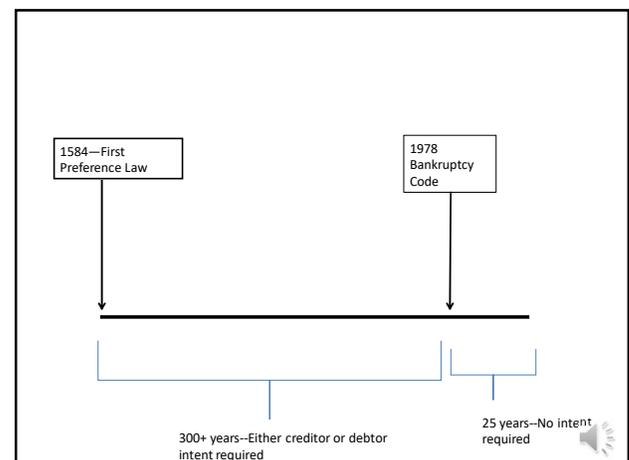


142

Past Laws Required Proof of Bad Intent—They Fought Bad Actors Not Preferential Transfers.



143



144



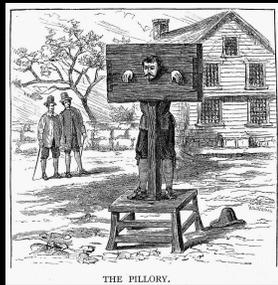
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145



146



147

Were the Elizabethans Right After All?



148

Criminalization—a Real Deterrent. Leave the ears but make them pay triple.



149

Law Seemed to Change in 1978 from Fighting Bad Actors to Fighting Preferences with Removal of Intent Requirement.



150

We Replaced True Deterrence with an Arbitrary and Unworkable Mechanical Test.



151

We Replaced A Law With Notice (conscious schemers know there will be a bankruptcy) with a Retroactive Law with No Notice.



152

The Problem With Proving Intention.



153

Circumstantial evidence.



154

Or an alternative paradigm.



155

Another Paradigm: Insider Trading.



156

Taking advantage of others by intentionally using secret knowledge in advance of an event.



157

Either way, we don't want to focus on fighting preferences. We want to focus on fighting bad actors.



158

Again--Make it a crime and require bad intent.



159

- Satisfies need for justice.
- Notice is inherent—they know there will be a bankruptcy.
- Real deterrence.
- More recovery.



160

Any transfer after insolvency.



161

No Exceptions for COD, After New Liens or Anything Else.



162

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