New York Law Journal
Corporate Update
WWW.NYLJ.COM
An ALM Publication
VOLUME 246—NO. 105
THRUSDAY, DECEMBER 2, 2011

SECURED TRANSACTIONS

# Bankruptcy Preferences: They Haven't Gone Away

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For generations, federal bankruptcy law has given trustees and debtors-in-possession (collectively, for simplicity, trustees) in Chapter 7 liquidation and Chapter 11 reorganization cases the power to "avoid," or invalidate, certain pre-bankruptcy preferential transfers and to add the recovered proceeds to the bankruptcy estate. Since the trustee's avoidance powers extend to transfers intended as security, not just absolute transfers, even secured claims are vulnerable to avoidance when the necessary preference elements can be established. Secured creditors have been comforted by several decisions over the past two decades that have made it easier to defeat preference attacks. A recent case, *O&G Leasing, LLC v. First Security Bank (In re O&G Leasing, LLC)*,[1] nevertheless provides a timely reminder to lenders that the power to avoid preferences remains a potent and oft-used weapon in the trustee's arsenal.

## Preferences Generally

Section 547 of the Bankruptcy Code[2] sets forth the basic statutory provisions regarding preferences. Under §547(b), preferences are transfers (1) made to or for the benefit of creditors (2) within the period of 90 days (or one year, for transfers made to the transferor's insiders) before the petition date (3) on account of "antecedent debt" (i.e., debt incurred pre-transfer) (4) while the transferor was "insolvent" (i.e., its liabilities exceed its assets, it expects to incur debts beyond its ability to repay or it has unreasonably small capital), and (5) that enable such creditors to receive more than they would have received in a Chapter 7 liquidation had the transfers not been made.

Transactions involving secured parties that are potentially vulnerable include, among others, taking liens to secure antecedent debt; filing UCC-1 financing statements and taking other actions to perfect previously-granted liens; and foreclosing upon or repossessing collateral. Creditors whose transfers are avoided as preferences receive claims against the estate for the value of the interests disgorged, but such so-called "resulting claims" are unsecured and, thus, usually yield far less than the value of the avoided transfers.

To establish a prima facie preference, trustees must show that all five definitional elements have been met, some being easier to demonstrate than others. Elements (1) and (3) are relatively mechanical. Element (4) is aided by §547(f)'s rebuttable presumption that debtors are insolvent throughout the 90 days before their petition date. Only for insider preferences occurring more than 90 days before the filing must trustees prove insolvency without the benefit of such presumption. Element (5) typically is satisfied unless transferees are otherwise fully secured or the bankruptcy estate has sufficient assets to pay all unsecured claims fully.

Element (2)'s timing requirement may seem mechanical at first blush, but it has generated debate over the years. Significant dispute has arisen regarding when the preference period ends (or, more accurately since it is counted backwards, begins). In *Barnhill v. Johnson*,[3] for example, the U.S. Supreme Court resolved one oft-litigated question by ruling that, for payments made by check, transfers occur not when debtors issue such checks but, rather, when banks honor them, thereby endangering checks issued beyond, but honored within, the preference period. The circuits are split as to whether preference periods that would otherwise end on weekends or holidays carry back to the next earlier business day.[4]

Since transfers, such as lien grants, are subject to avoidance as preferences only if they occur during the preference period, pinpointing the exact time transfers were made can be critical. When a security interest encumbers personal property, §547(e)(2) provides relevant guidance: The transfer is deemed made (a) on the actual date of transfer if perfection occurs within 30 days thereafter; (b) on the date of perfection, if perfection occurs more than 30 days after the transfer; and (c) immediately before the filing of the bankruptcy petition, if the transfer has not been perfected by the later of the petition date and 30 days after the transfer.

If preference law lacked exclusions, of course, it would cover so many transactions that few creditors would be willing to conduct business with entities heading toward bankruptcy. To avert this counterproductive effect, §547(c) provides exemptions, which may be pleaded as affirmative defenses, for various transfers that technically satisfy §547(b)'s elements. Five of these defenses are particularly useful to secured creditors in non-consumer transactions.

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First, §547(c)(3) protects purchase-money security interests, *provided* the secured parties perfect their liens within 30 days after the debtors take possession of the collateral. This grace period is actually longer than the similar 20-day grace period that UCC §9-330(e) provides for perfecting purchase-money security interests.

Second, transfers (including pledges) that are intended to be made in exchange for

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contemporaneous new value—thus not on account of antecedent debt—and that are in fact substantially contemporaneous, are exempt under §547(c)(1). This "new value" defense is available only for the amount of the new value given. If a lender lends an additional $100 to the debtor in exchange for $250 of new collateral, for example, the defense applies only to $100 of the collateral transferred. The remaining $150 is not protected from avoidance. Nor can the defense shield purchase-money liens remaining unperfected after §547(c)(3)'s 30-day grace period. Moreover, established case law makes clear that merely forbearing from exercising remedies does not constitute "new value" for preference purposes[5] and therefore is not a defense to a preference.

Third, temporally complementing the new-value defense, §547(c)(4) protects transfers made on account of antecedent debt to the extent the creditor subsequently gives the debtor new value that is neither repaid prepetition nor secured by otherwise-avoidable liens. Where debtors and creditors made numerous exchanges during the preference period, creditors asserting this "subsequent advance" defense often have to present complicated spreadsheets matching transfers and subsequent advances.

Fourth, §547(c)(2) insulates payments made in the ordinary course of business, or according to ordinary business terms, respecting debts that were incurred in the ordinary course of business. The Supreme Court has held that this exemption applies to regularly-scheduled payments of long-term funded debt, not just payments on short-term funded debt or payments of trade debt.[6] Additionally, even late payments might qualify as "ordinary course" if made consistently with the debtors' and creditors' prior dealings or with applicable industry practices.[7]

Finally, §547(c)(5) prevents floating liens on inventory or accounts receivable from triggering multiple avoidable transfers due to fluctuations in the value of such collateral during the preference period. Inventories and receivables, by their very nature, increase and decrease frequently, often daily. Absent a special accommodation, each such increase during the preference period could be considered a preferential transfer, even if it were reversed by a subsequent decrease. To preempt this result, such increases are avoidable only to the extent a secured party's aggregate net position has improved during the period from the later of the first day of the preference period or the first date on which the secured party gave new value under its security agreement, and ending on the petition date.

Supplementing the statutory defenses is "earmarking," a case-law doctrine shielding certain otherwise-preferential transfers to existing creditors made with funds provided by new creditors. The U.S. Court of Appeals for the Eighth Circuit has articulated an oft-followed three-part test for earmarking:

(i) the new creditor and the debtor must have expressly agreed that the new funds be used to pay specified antecedent debt;

(ii) that agreement must have been performed according to its terms; and

(iii) the transaction viewed as a whole must not have diminished the estate.[8]

Earmarking might thus protect unsecured or undersecured lenders who are refinanced during the preference period by new lenders who obtain no more collateral from the debtor than the repaid lender had. The "no diminution of estate" criterion, however, effectively bars an unsecured or undersecured lender from exploiting the earmarking defense if the new lender is better secured, because the swap of unsecured or undersecured debt for better-secured debt would reduce the assets available for unsecured creditors.[9]

## 'O&G Leasing'

On Aug. 26, 2011, the Bankruptcy Court for the Southern District of Mississippi issued its opinion in *O&G Leasing*, an adversary proceeding dealing with the avoidability of a lien on various drilling rigs. From 2006 to 2008, O&G Leasing, LLC (O&G) acquired five oil and gas drilling rigs, financed through a series of debentures. First Security Bank (FSB) was the indenture trustee for the debentures, which were secured by the specific drilling rigs purchased from the proceeds of the respective debentures. FSB's security interests were perfected via UCC-1 financing statements filed with the Mississippi Secretary of State, and those UCC-1s were never terminated.

In 2009, O&G and FSB entered into an exchange offer to roll the earlier debentures into a single consolidated debenture that would be secured by the same drilling rigs as the earlier debentures. O&G and FSB also entered into a security agreement on Sept. 15, 2009 for this collateral. However, the exhibit that described the collateral was not attached to the 2009 security agreement until after it had been signed. FSB filed a UCC-1 on March 9, 2010, more than 30 days after the 2009 security agreement was signed and less than 90 days before O&G filed a Chapter 11 petition on May 21, 2010.

In the adversary proceeding, O&G argued, inter alia, that FSB's security interest in the drilling rigs was invalid because the 2009 security agreement lacked an adequate collateral description when it was executed and because the 2010 UCC-1 filing was a preference since it was made during the preference period.

The court held that the 2009 security agreement described the collateral sufficiently for FSB's security interest to attach to the drilling rigs. Under UCC §9-108, any description of collateral is sufficient, even if not specific, as long as it reasonably identifies what is described. The court ruled that, despite the collateral exhibit's absence, the collateral to which FSB's lien attached was identified elsewhere in the 2009 security agreement reasonably enough to place third parties on notice. The court also determined that, although the collateral exhibit was not attached until after the 2009 security agreement was signed, the agreement was enforceable because Article 9 does not dictate any particular order in which its requirements to create a security interest must be fulfilled.[10]

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The court then held that, despite having been made during the preference period, the 2010 UCC-1 filing was not an avoidable preference for two reasons. First, since FSB already had its earlier UCC-1s in place perfecting its security interest in the five rigs when the 2010 UCC-1 was filed, the 2010 UCC-1 filing did not entitle FSB to receive any greater distribution than it would have received had that financing statement not been recorded. Thus, Element 5 of a preference—i.e., that the transfer enables the creditor to receive more from the estate than it would have received in a Chapter 7 liquidation had the transfer not been made—could not be established.[11]

Second, the filing of the 2010 UCC-1 did not even constitute a transfer at all. Under §547(e)(1)(B), a transferee of a lien on personal property is deemed to have a perfected interest in the property when a hypothetical creditor on a simple contract cannot acquire a judicial lien superior to the transferee's interest. Because the 2010 UCC-1 was filed when FSB already had a pre-existing security interest in the rigs perfected by prior financing statements that had not been terminated and remained in effect, there was no break in the perfection of the lien. Thus, the 2010 UCC-1 merely continued an

existing security interest that pre-dated the start of the preference period.[12]

## Observations

The decision in *O&G Leasing* prompts several observations.

• The case involves no noteworthy or novel legal issues, nor were its facts in dispute. Indeed, the court decided the matter on a motion for summary judgment, citing numerous cases in support of its holdings. Yet, the very banality of the case is disturbing; O&G commenced the preference action and forced FSB to defend itself even though the case lacked merit.

• *O&G Leasing* illustrates that any deficiency in documentation or delay in perfection, however immaterial or illusory, can serve as grist for a trustee's preference-litigation mill.

• Although the preference attack here was rebuffed successfully, the failure to attach the collateral exhibit or to perfect quickly might have been fatal had the facts differed slightly, say if (as is often the case) the security agreement had no additional collateral description buttressing the omitted exhibit or if no UCC-1s were already on file and in effect.

• The 30-day grace period that §547(e)(2)(A) allows for perfection is useful if circumstances prevent secured parties from pre-filing. This is especially the case if the debtor files a bankruptcy petition during that period, since an action to perfect a security interest is one of the few things not subject to the Bankruptcy Code's automatic stay, *provided* such action is in fact accomplished within that period.[13] Nevertheless, lenders and practitioners should minimize reliance on the grace period, particularly when dealing with debtors verging on bankruptcy. One can never be sure that action to perfect will be accomplished within 30 days after closing, and if a bankruptcy intervened, any delay beyond 30 days, regardless of cause, would expose the secured party to a preference attack that could render it unsecured. Even without an intervening bankruptcy, delays in perfection expose secured parties to the risk of being primed by other intervening secured creditors, judgment creditors or statutory lienholders, and the longer the delay, the greater the risk.

• In addition to perfecting their liens as quickly as possible, lenders need to maintain the continued effectiveness of their perfection and to monitor their debtors and collateral vigilantly. Trustees reflexively commence preference actions to avoid liens where perfection might have lapsed, either because of the secured party's failure to timely file UCC continuation statements (or the equivalent under other laws that might apply to the collateral) or because of some action by the debtor that arguably impairs perfection, such as changing its name, location or form of enterprise, etc. Even if the secured party ultimately prevails, it will have borne the costs and risks of litigation it might have avoided by policing its security better.

• Although undersecured or unsecured lenders whose loans to insolvent borrowers are being refinanced should not be ungrateful about the source of the new money, they do need to monitor the new financing transaction if they want the earmarking defense to protect them from subsequent preference attack. In particular, they should ensure that the debtor and new lender agree expressly that the new funds be used to repay the refinanced lenders' debt and that such agreement is performed according to its terms. Ideally, they should also make sure that the new lender receives no more security than the refinanced lenders had. This is challenging in practice if the borrower has valuable unencumbered collateral, however, since most arms'-length new lenders would likely require liens on all assets as a condition to lending to a troubled borrower.

• Undersecured lenders to a financially strapped debtor should also take steps to preserve §547(c)(2)'s "ordinary course of business" defense. In particular, they should ensure that all installments of the debt are made when due under the terms of the credit agreement or, if the lenders have regularly accepted late payments, no later than they have historically allowed. The lenders should act quickly thereafter to address any non-payment or to enforce their rights and should not allow the debtor to "stretch" its payments to them without consequence.

• Secured parties that have received patently-avoidable preferential transfers may benefit from extending additional credit to the debtor if doing so will help keep it out of bankruptcy long enough for the preference period (and, thus, the secured parties' disgorgement risk) to expire. Creditors considering this must assess various factors, such as the value of the transfers they received, how much new credit they would have to provide, and the likelihood the debtor will nevertheless file a voluntary bankruptcy petition or suffer one being filed against it involuntarily during the preference period.

## Conclusion

The Bankruptcy Code's preference provisions remain a significant risk for the secured lender. They can be a costly nuisance even where documentation or perfection shortcomings are immaterial, as in *O&G Leasing*, since trustees seize upon any deficiency in their campaign to avoid secured claims. Lenders should thus minimize their exposure to preference attack by completing security documentation and perfecting liens promptly, monitoring their collateral and debtors attentively, and timely taking appropriate steps to maintain the continuity of their perfection.

*1. 456 B.R. 652 (Bankr. S.D. Miss. 2011).*
*2. 11 U.S.C. §§101, et seq.; §547.*
*3. 503 U.S. 393 (1992).*
*4. See MBNA America v. Locke (In re Greene), 223 F.3d 1064 (9th Cir. 2000).*
*5. See, e.g., In re ABC-NACO Inc., 483 F.3d 470, 473 (7th Cir. 2007); Lyndon Prop. Ins. Co. v. E. Ky. Univ., 200 Fed. Appx. 409, 418-19 (6th Cir. 2007); In re Pameco Corp., 356 B.R. 327, 339 (Bankr. S.D.N.Y. 2006).*
*6. Union Bank v. Wolas, 502 U.S. 151 (1991).*
*7. See, e.g., In re A.W. & Assocs. Inc., 136 F.3d 1439 (11th Cir. 1998); In re U.S.A. Inns Inc., 9 F.3d 680 (8th Cir. 1993); In re Tolona Pizza Products Corp., 3 F.3d 1029 (7th Cir. 1993).*
*8. McCuskey v. Nat'l Bank of Waterloo (In re Bohlen Enterprises, Ltd.), 859 F2d 561 (8th Cir. 1988).*
*9. Betty's Homes Inc. v. Cooper Homes (In re Betty's Homes Inc.), 393 B.R. 671 (Bankr. W.D. Ark. 2008).*
*10. O&G Leasing, 465 B.R. at 665-66.*
*11. Id. at 669.*
*12. Id. at 670-71.*
*13. 11 U.S.C. §362(b).*

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