



# Cutting Edge Bankruptcy Issues

## Webinar Presentation For ABC-Amega

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# Section 503(b)(9) “20 Day” Administrative Priority Claims

- Administrative Claim for the Value of the Goods the Debtor Received Within 20 Days of Bankruptcy Filing
- 20 Day Goods Must be Sold to the Debtor in the Ordinary Course of the Debtor’s Business
- Safety Net for Trade Creditors that Supply Goods Not Services!
- Replaces Reclamation as an Effective Value Maximizing Trade Creditor Remedy

# Assertion Of “20 Day” Goods Administrative Claims And Timing Of Payment

- General Rule – § 503(b)(9) Request/Allowance Requires Notice and a Hearing
  - No automatic administrative claim without court approval
- There is No Federal Bankruptcy Rule Specifying the Manner in Which to Assert § 503(b)(9) Priority Claims
  - Can creditor assert § 503(b)(9) claim via proof of claim without prior Court approval? Risky!
- Timing of Payment - Most Courts Have Rejected Immediate Payment Over Debtor’s Objection
  - Instead, Payment Upon Confirmation of Plan or Earlier if Motion to Pay § 503(b)(9) Claims is Filed by Debtor

# Deadline To Assert “20 Day” Goods Administrative Claims

- No Deadline to Assert § 503(b)(9) Claims in Statute
- Local Bankruptcy Rules may Create Deadline
  - U.S. Bankruptcy Court, Eastern District, Michigan
    - Local Bankruptcy Rule 3003-1 – Deadline to file proof of claim, or § 503(b)(9) motion in chapter 11 case: 90 days after first date set for § 341 meeting of creditors
  - U.S. Bankruptcy Court, District of Massachusetts
    - Local Bankruptcy Rule 3002-1 – Deadline to file request for allowance of § 503(b)(9) claim: 60 days from first scheduled § 341 meeting date

# Deadlines/Assertion Of “20 Day” Goods Administrative Claims

- Courts are Also Setting Deadlines for Asserting § 503(b)(9) Priority Claims
  - One deadline to file claims that includes § 503(b)(9) priority claims and all other general unsecured claims
  - **Alternate deadline:** Separate deadline for asserting § 503(b)(9) claims from general unsecured claims
  - Courts are also prescribing the manner of asserting § 503(b)(9) claims, either
    - On the same claim form as the creditor’s general unsecured claim
    - or-
    - On a special proof of claim form solely related to § 503(b)(9) claims

# One Of § 503(b)(9)'s Most Frequently Litigated Issues: Meaning Of Receipt Of Goods

- Section 503(b)(9) Does Not Define “Receipt”
- Actual Possession (UCC)?
  - UCC-2 § (103)(1)(c)
    - “Receipt of goods means taking physical possession of them”
- Is Constructive/Third Party Possession Enough?

# Decision of U.S. Court of Appeals For the Third Circuit in *In re World Imports, Ltd.*: Goods “Received” Upon Physical Possession

- “Received” in § 503(b)(9) Means a Debtor’s or Its Agent’s Actual Physical Possession of Goods
- Reversed Lower Court Rulings That a Debtor “Received Goods” Upon Delivery to Common Carrier Based on FOB (Free on Board) Port of Shipment (in China)
- Rejected Applicability of Convention of Contracts for the International Sale of Goods (CISG)
- The Court Relied on the Dictionary Definitions of “Receive”, the Uniform Commercial Code Definition of “Receipt”, and how Earlier Third Circuit Precedent Addressing how Reclamation Rights Required Actual Physical Possession

# Decision of U.S. Court of Appeals For the Third Circuit in *In re World Imports, Ltd.*: Goods “Received” Upon Physical Possession

- Receipt Does not Occur Until Termination of Seller’s Ability to Stop Delivery of Goods
  - This occurs upon debtor’s/agent’s actual physical possession of goods
    - However, who qualifies as an agent? Common carrier?
- Third Circuit’s Ruling is Beneficial to Goods Sellers
  - Delayed occurrence of “receipt” of goods might increase the amount of goods received within § 503(b)(9)’s 20 day window, particularly for goods being imported from outside the United States



# ■ Applicability of § 503(b)(9) To Drop Shipped Goods

- Drop Shipment?
- Creditor Ships Goods to a Third Party at the Debtor's Instruction
  - Debtor's agent
  - Debtor's customer
- Issue: Debtor Never Received Actual Physical Possession of Goods

# Receipt Of Goods: Drop Shipment

- *In re Momenta, Inc.* – U.S. District Court of New Hampshire Affirming U.S. Bankruptcy Court Decision
  - Receipt includes buyer’s physical or constructive possession of goods
- Buyer Does not Obtain Constructive Possession of Goods That are Delivered to Buyer’s Customer Under Drop Shipment Arrangement
  - Constructive possession should be narrowly interpreted to occur upon proof of receipt of goods by a buyer’s agent
- Adopted Black’s Law Dictionary Definition of “Drop Shipment Delivery” as a “Manufacturer’s Shipment of Goods Directly to the Consumer Rather Than Initially to a Wholesaler”
- The Creditor’s § 503(b)(9) Priority Claim for Drop Shipped Goods was Denied

# Drop Shipment: Competing Views

- *SRC Liquidation LLC (f/k/a Standard Register)* – U.S. Bankruptcy Court, District of Delaware
- Court Denied § 503(b)(9) Priority Status to Seller that Delivered Goods to a Common Carrier for Shipment to Debtor’s Customer During the 20 Days Before the Debtor’s Chapter 11 Filing
  - Court relied on Third Circuit’s *World Imports* ruling
  - Neither debtor nor debtor’s agent took actual physical possession of goods
  - **Common carrier deemed not to be debtor’s agent**
- Contrary View: Official Comment 2 to § 2-705 of the Uniform Commercial Code Which Specifically States:
  - “[r]eceipt by the buyer includes receipt by the buyer’s designated representative, the sub-purchaser, when shipment is made direct to him and the buyer himself never receives the goods”

# Receipt Of Goods: Drop Shipment

- Can “Receipt” be Defined in Parties’ Agreement to Occur Upon Buyer’s Customer’s Receipt of the Goods?
  - **Suggested Language:** “Receipt of any product by buyer shall immediately occur when buyer, buyer’s bailee or other agent or designee receives either actual or constructive possession of such product. Constructive possession shall include, without limitation, receipt by an entity or individual (including, without limitation, buyer’s customer) pursuant to a drop ship instruction or other delivery instructions from buyer. Constructive possession specifically does not require actual physical possession by the buyer.”
- There are no Reported Court Decisions That Allow or Discuss the Propriety of “Contracting Around” the Definition of “Receipt”

# Debtor's Setoff Rights As A Defense To § 503(b)(9) Priority Claims

- Chapter 11 Debtors Have Sought to First Offset Pre-Petition Credits, Deductions, Chargebacks, Overpayments and Rebates, **in Reduction of a Creditor's § 503(b)(9) Priority Claim**, Instead of the Creditor's Less Valuable General Unsecured Claim
- *Circuit City Stores* (Bankruptcy Court, Eastern District of Virginia) and *In re ADI Liquidation, Inc.* (Bankruptcy Court, District of Delaware) Decisions
  - The Debtor was permitted to setoff pre-petition credit claims to first reduce § 503(b)(9) priority claims
  - The courts invoked Bankruptcy Code § 558:
    - “The estate shall have the benefit of any defense available to the debtor...”
  - Taken to its logical extreme, the Debtor could also offset pre-petition credits claims against a creditor's unpaid post-petition administrative claims — **VERY DANGEROUS!**
    - Post-petition credit should be conditioned on the Debtor's agreement not to deduct pre-petition credits and other related claims

# Debtor's Setoff Rights As A Defense To § 503(b)(9) Priority Claims

## ■ Proposed Contractual Fixes

- “Buyer waives any right to assert pre-petition credits, deductions, chargebacks, overpayments, rebates and similar claims if Buyer is “not in good standing” with Seller (i.e., Buyer is past due or otherwise in default; out of business)”
- “Buyer waives the right to assert any right of setoff, recoupment or any other defense with respect to any credits, deductions, chargebacks, overpayments, rebates and similar claims that Seller owes Buyer to reduce Buyer’s indebtedness to Seller”
- “Seller shall be permitted to apply all credits, deductions, chargebacks, overpayments, rebates and similar claims owed to the Buyer in reduction of indebtedness owing by the Buyer to Seller as determined by Seller at its sole discretion.” (e.g., apply credits against oldest non-§ 503(b)(9) invoices first)

# Debtor's Setoff Rights As A Defense To § 503(b)(9) Priority Claims

- Enforceability of Proposed Provisions in Bankruptcy? No Reported Decisions Address This Issue/Language
- Note the Following Caveat in the Delaware Bankruptcy Court's *AWI* Opinion:

“...I conclude that there is a presumption that the claimants' prior course of dealing, industry standards and *contract* do not operate as a waiver of the Debtors' equitable remedies. However, if a claimant believes that its course of dealing or contractual language provide a good faith basis for arguing that the Debtors have waived their equitable remedies, then the claimant shall have the right to a hearing on the merits of their claim to rebut the presumption.”

# Preference Claim As Grounds For Disallowance Of § 503(b)(9) Administrative Priority Claim (§ 502(d) Of the Bankruptcy Code)

- Courts are Divided Over Whether a Preference Claim (Complaint Filed or Otherwise Asserted) can be Invoked to Temporarily Disallow a § 503(b)(9) Priority Claim
- **One View:** Preference Claim not Grounds for Disallowance of § 503(b)(9) Priority Claim
  - *In re Energy Conversion Devices, Inc. and Plastech Engineered Products, Inc.* – U.S. Bankruptcy Court, Eastern District of Michigan
  - *In re TI Acquisition LLC* – U.S. Bankruptcy Court, Northern District of Georgia
  - *In re Momenta, Inc.* – U.S. Bankruptcy Court, New Hampshire
- **Contrary View:** Debtor could assert preference claim as basis for temporarily disallowing § 503(b)(9) priority claim
  - *In re Circuit City* – U.S. Bankruptcy Court, Eastern District, Virginia



## ■ Bankruptcy Reclamation

- Avoidance Powers of a Trustee are Subject to the Rights of a Seller of Goods That has Sold Goods to a Debtor in the Ordinary Course of a Seller's Business to Reclaim Such Goods if the Debtor has Received Such Goods While Insolvent, Within 45 Days Before Commencement of a Bankruptcy Case

# ■ Bankruptcy Reclamation

- Written Reclamation Demand Required
- Demand Must be Received by Debtor no Later Than 20 days After Bankruptcy Filing
- Debtor's Insolvency – Balance Sheet Test (Liabilities Greater Than Assets)
- Reclamation Rights Limited to Goods Still in Debtor's Possession
  - Only remedy – return of goods
  - No provision for alternative remedy of administrative claim (like previously) if reclamation claim is denied

# ■ Bankruptcy Reclamation

- **WARNING !!! A SELLER'S RECLAMATION RIGHTS ARE STILL SUBJECT TO THE PRIOR RIGHTS OF A CREDITOR WITH A SECURITY INTEREST/FLOATING LIEN IN SUCH GOODS**
- Are Reclamation Claims Rendered Valueless by a Debtor's Pre-Petition Secured Inventory Lender?
  - There is a division among courts

## ■ Bankruptcy Reclamation – Prior Lien Defense

- *Dana Corporation* (Bankruptcy Court, Southern District, New York, 2007)  
Relying on *Dairy-Mart Convenience Stores, Inc.*, Bankruptcy Court Southern District of New York, 2002
  - Prior lien defense renders reclamation claims valueless, despite repayment of pre-petition secured loan by post-petition DIP financing

# Bankruptcy Reclamation Prior Lien Defense – A Contrary View

- 6<sup>th</sup> Circuit Court of Appeals Decision in *Phar Mor* Case
- Reclamation Goods Used to pay off Secured Creditor
- Unencumbered Cash (\$30 Million) Available for Distribution to Unsecured Creditors if Reclamation Claims Have no Priority Status

# Bankruptcy Reclamation Prior Lien Defense – A Contrary View

- Relying on Pre-2005 Amendments Reclamation Statute (§ 546(c) of the Bankruptcy Code, 6<sup>th</sup> Circuit Ruled That if Bankruptcy Court Denies Reclamation, Reclaiming Creditor is Entitled to Administrative Claim)
- Rejected *Dana* and Other Court Holdings That Reclamation Rights are Wiped out if Proceeds of Goods Were Used to Pay Down Secured Claims

# Bankruptcy Reclamation Prior Lien Defense – A Contrary View

- Delaware Bankruptcy Court Decision: In *In re Reichhold Holdings Inc.*
  - Overruled trustee's limited objection to creditor's administrative claim based on its reclamation rights
  - Agreed with *Phar Mor* decision
  - Disagreed with *Dana Corporation* and *Dairy-Mart* decisions
  - Court reserved all rights to object to the reclamation claim on other grounds

## ■ Bankruptcy Reclamation Prior Lien Defense

- U.S. Court of Appeals – 7<sup>th</sup> Circuit, in *In re hhgregg Inc.*, Sided With *Dana* Decision – Blanket Inventory Security Interest Prevails Over Reclamation Claims



# Recent Court Decision Denying Administrative Claim to Creditor Asserting Reclamation Rights

- *Specialty Shops Holding Corp (Shopko)*: United States District Court, District of Nebraska
- Court Denied Trade Creditor's Request for Payment of its Reclamation Claim as an Allowed Administrative Claim
  - 2005 BAPCPA amendment to § 546(c) eliminated a reclaiming creditor's right to an allowed administrative claim, except for priority rights under § 503(b)(9)
  - Creditor had no right to proceeds of goods subject to reclamation because Shopko owed its secured lender far more than the value of the goods
- The District Court's *Shopko* decision is currently on appeal to the 8<sup>th</sup> Circuit Court of Appeals

# Reclamation Catch 22

- *Circuit City Stores* (U.S. District Court, Eastern District of Virginia)
  - Creditor forfeited reclamation rights by just sending written reclamation demand and then failing to seek recovery of goods
- Catch 22: Creditor That Pursues Reclamation Rights Would Still Likely not be Entitled to Relief Because Pre-Petition Lenders' Blanket Floating Lien on Inventory Renders Reclamation Claim Valueless
- Useless Remedy?
- Election of Remedies?
- Reclamation a Hollow Remedy?
  - Sounds great on paper
  - Recovery prospects uncertain, but possible (*Gander Mountain*)!
  - Send reclamation demand and don't ignore this remedy!

# ■ Executory Contracts

- Bankruptcy Code Does Not Define “Executory Contract”
- Courts Generally Apply “Countryman Definition” of Executory Contracts:
  - An executory contract is one under which both parties to the contract have unperformed obligations such that the failure of either party to continue or complete performance would constitute a material breach that excuses the other party from performance.

# Executory Contracts

- Non-Debtor Parties Must Perform Under Executory Contracts Until they are Assumed or Rejected
  - Goods seller or service provider, if bound by contract, is required to continue selling/providing services to debtor
  - Is non-debtor obligated to continue extending credit post-petition if required by contract?
    - Contract terms and/or UCC credit remedies (adequate assurance/stoppage of delivery) might permit switch to CIA
    - Be careful!
  - Creditor's Failure to Fulfill Terms of Any Executory Contract Risks Debtor's Assertion of Claims of Breach of Contract and Violation of Automatic Stay

# Executory Contracts

- Assumption, Rejection and Assignment Require Court Approval, and Assignment Often Is Part of the Sale of the Debtor's Business and/or Assets
- Time Frame for Assumption/Rejection of Most Executory Contracts
  - Any time prior to or upon confirmation of plan
  - Non-debtor party can seek to shorten period by moving in bankruptcy court compelling debtor to assume/reject contract within specified time period, and/or seeking adequate protection (e.g., deposit, letter of credit or cash in advance terms)
    - Very difficult to obtain early in case

# ■ Executory Contracts

- Profitable or Necessary Contracts Are Often Assumed/Assigned
  - Cure of all arrears and defaults
  - Adequate assurance of future performance by Debtor or Assignee
- Unprofitable/Burdensome Contracts are Rejected
  - Creditors are entitled to assert a contract rejection damages unsecured claim and stop performing
  - Creditors are entitled to assert an administrative priority claim for goods delivered or services rendered post-petition

# ■ Carefully Review Notices of Cure Amounts

- Creditors Should Carefully Review Proposed Cure Amounts Payable to Creditors on Assumed and/or Assigned Executory Contracts to Assure Consistency With the Amount of Creditors' Claims
  - Cure amounts generally listed in schedule attached to notice sent to all creditors that are parties to executory contracts in the context of sale of Debtor's assets/business
  - Be prepared to retain counsel to object to cure amount or lack of adequate assurance of future performance

- **Unenforceability of “Ipso Facto Clauses”**
  - **Ipso Facto Clause Unenforceable in Bankruptcy**
    - **Modifies/terminates contract upon insolvency/poor financial condition, including customer’s bankruptcy**
    - **“Safe Harbor” exception**



# ■ Creditor Can Force Issue

- Motion to Compel Assumption or Rejection Via 11 U.S.C. §365(d)
  - Court may order the trustee/debtor to determine within specified period of time to assume or reject such contract
- Debtor's Quick Assumption of Contract (rare!)
- Debtor's Payment of Post-Petition Claims
- Debtor May Agree to Release Creditor From Contract
- Creditor May be Able to Negotiate More Favorable Terms or Risk Backstop, Such as Letter of Credit or Deposit
- Debtor May Agree to Deadline for Assumption/Rejection

# Preference: Elements Of Claim

- 1) Any Transfer of an Interest of the Debtor in Property;
- 2) To or for the Benefit of a Creditor;
- 3) On Account of an Antecedent Debt Owed by the Debtor Before the Transfer:
  - Cash in advance payments not preferences
- 4) Made While the Debtor was Insolvent;
  - On or within 90 days before a bankruptcy filing; or
  - Between 90 days and one year before a bankruptcy filing for transfers made to insider creditors; and
- 5) That Enables Such Creditor to Receive More Than Such Creditor Would Receive if:
  - The case were a Chapter 7 case;
  - The transfer had not been made; and
  - Such creditor received payment to the extent provided by other provisions of the Bankruptcy Code.

# SBRA's Changes To Preference Law With The Goal of Avoiding Abusive Practices

- Bankruptcy Code §547(b) was Amended to add the Following Purported due Diligence Requirement to be Undertaken Before Filing Preference Litigation:
  - “(b) Except as provided in subsections (c) and (i) of this section, the trustee may, *based on reasonable due diligence in the circumstances of the case taking into account a party’s known or reasonably knowable affirmative defenses under subsection (c)*, avoid any transfer of an interest of the debtor in property....”
  - Preference defendants still have the burden of proving preference defenses
  - It is unclear what this requirement actually means and what is actually required (no case law addressing the issues)

# Preference Defenses: Contemporaneous Exchange For New Value (COD)

- Transfer was *Intended* by the Debtor and the Creditor to be a Contemporaneous Exchange for New Value; and
- Transfer was in fact a Substantially Contemporaneous Exchange
- Examples:
  - COD transaction: payment tendered for delivery of goods
    - Risk of bounced COD check/ACH payment; the replacement payment is covered by this defense

# Preference Defenses: New Value

- Creditor Extending Credit to Debtor After Payment, That was not Secured, and not Paid, by an Otherwise Unavoidable Transfer
- New Value Cannot be Applied to Subsequent Payments
- Paid new value May Count to Reduce Preference Exposure
- U.S. Circuit Courts of Appeal are Divided on Whether Paid new Value Counts, Although the Trend is Toward Allowing Paid new Value:
  - 4<sup>th</sup>, 5<sup>th</sup>, 8<sup>th</sup>, 9<sup>th</sup>, and most recently 11<sup>th</sup> say Yes!
  - 7<sup>th</sup> says No!
  - 3<sup>rd</sup> Circuit's prior "No" is now in question – likely open
  - Other Circuits have not considered the issue

# Most Recent Circuit Decision: U.S. 11<sup>th</sup> Circuit Court of Appeals Counts Paid New Value

- *BFW Liquidation, LLC (f/k/a Bruno's Supermarkets)*
- On 8/14/18, the 11<sup>th</sup> Circuit Held That the New Value Defense can Include Paid new Value
  - According to the plain language of §547(c)(4), the new value defense does not require that new value remain unpaid
  - Limiting new value defense to unpaid new value would hinder policy objective of encouraging vendors to continue extending credit to financially troubled debtors
    - Most relevant to situations where the payment terms are short

# Critical Vendor Preference Risk

- Does Critical Vendor's Receipt of Post-Petition Payment of Pre-Petition Claim Result in Loss of § 547(c)(4) new Value Defense to Preference Claim?
  - The U.S. Court of Appeals 3<sup>rd</sup> Circuit's Decision in *In re Friedman's* counts new value paid post-petition pursuant to court order because new value is determined as of the bankruptcy filing date
    - The Court should take a snap shot as of the petition date
  - Other U.S. Circuit Courts of Appeal have not yet ruled on this issue
  - Certain lower courts have disqualified new value paid post-petition
  - **Suggestion:** Critical vendor order should either release preference claims against the vendor, or preserve the new value defense
    - This protection might be hard to obtain unless the creditor has a lot of leverage, but is important now based on positions that debtors and post-confirmation entities have recently been taking.

# Is Paid § 503(b)(9) Claim Eligible As New Value?

- **Yes:** *In re Commissary Operations, Inc.*, U.S. Bankruptcy Court, Middle District of Tennessee
  - New value window closes on bankruptcy filing date (same analysis applied by 3<sup>rd</sup> Circuit court in *In re Friedman's*)
  - The new value defense is not impacted by post-petition payments of new value
  - Section 503(b)(9) claims are improperly impaired if excluded from the new value defense



# Paid § 503(b)(9) Claim Is Not Eligible As New Value

- **No:** *In re Circuit City Stores* (U.S. Bankruptcy Court, Eastern District of Virginia) and *In re TI Acquisition LLC* (U.S. Bankruptcy Court, Northern District of Georgia)
- Paid § 503(b)(9) Priority Claim Does Not Satisfy Bankruptcy Code § 547(c)(4)'s Requirement That “the Debtor did not Make an Otherwise Unavoidable Transfer to or for the Benefit of Such Creditor” as a Post-Petition Payment was Received by the Creditor
- A Creditor is Double Dipping if it can use its Fully Paid/Funded § 503(b)(9) Claim as Part of its new Value Defense

# Ordinary Course Of Business Preference Defense

- 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 Creditor; and
- Subjective Test – Made in the Ordinary Course of Business or Financial Affairs of the Debtor and the Creditor; OR
- Objective Test – Made According to Ordinary Business Terms
- The Creditor can Choose the Most Beneficial (Subjective or Objective) Prong of the Ordinary Course of Business Defense

# Subjective Component Of The Ordinary Course Of Business Defense

- Courts Have Been Inconsistent and Unpredictable in Applying the Subjective Component of the Ordinary Course of Business Defense
- Each Side can Pick one or More Methodologies to Support its Position
- This Encourages Expensive and Drawn out Litigation

# Ordinary Course of Business: Subjective Component – Litigated Issues

- Range of Views:
  - How long of a pre-preference period payment history?
    - 1 Year?
    - 2 Years? Bankruptcy Court, Southern District, New York decision: *Quebecor World*
    - Longer?
    - Entire history?

# Ordinary Course of Business: Subjective Component – Baseline For Comparing Preference Payments Vs. Prior/Historical Payments

- Range of Payments:
  - All payments?
  - Modified range?
  - Removal of outliers?
  - Payments only when Debtor is healthy? (*Circuit City* Bankruptcy Court decision from Eastern District, Virginia)
- *Sparrer Sausage Co.* – 7<sup>th</sup> Circuit U.S. Court of Appeals Decision
  - 7<sup>th</sup> Circuit rejected Bankruptcy Court’s use of historical (pre-preference period) baseline of only 64% of invoices paid
  - Court instead accepted historical baseline of 88% of invoices paid (larger % more generous to the creditor)
  - Like *Circuit City*, the 7<sup>th</sup> Circuit did not overturn the Bankruptcy Court’s refusal to consider payments within 7 months of the start of the preference period when the Debtor was not “financially healthy”

# Ordinary Course of Business: Subjective Component – Baseline For Comparing Preference Payments Vs. Prior/Historical Payments

- Comparison of Average Days to pay/Days Late Prior to and During Preference Period
- *Archway Cookies* Bankruptcy and District Court Decisions in Delaware –
  - Payments determined to be shielded by subjective prong of ordinary course of business defense, notwithstanding approximately 5 day difference in average days-to-pay during historical period (42.3 days) compared to preference period (47.2 days)
- Bucket Analysis – Examining Payments by Grouping – Accepted by *Quebecor World*, Bankruptcy Court, Southern District of New York
  - Risk of skewed analysis

# ***Sierra Concrete Design Inc.*; United States Bankruptcy Court, Delaware: Comparing Preference Payments Vs. Prior/Historical Payments**

- *Quebecor World*, Bankruptcy Court, Southern District of New York – Subjective Ordinary Course of Business Defense Inapplicable
  - 30 days off average (27.56 average days-to-pay during the pre-preference period versus 57.16 average days-to-pay during preference period) was too many days
    - Court relied on weighted average, which was not disputed
- *Sierra Concrete Design*, Bankruptcy Court, Delaware - Defendant Proved Subjective Ordinary Course of Business Defense After Trial
  - Did not matter that debtor paid invoices 27.9 days on average faster during preference period
    - Average days-to-pay during pre-preference period was 55.22 days
    - Average days-to-pay during preference period was 27.3 days

# Subjective Prong Of Ordinary Course Of Business Preference Defense

## Facts That may Defeat Subjective Ordinary Course of Business Defense Despite Consistency of the Numbers

- Consistency in Timing of Payments Before and During the Preference Period Alone Might not be Sufficient to Prove Subjective Component of Ordinary Course of Business Defense
- Threats to Subjective Component:
  - Change in the type of payment during preference period (regular check to wire, ACH, etc., or vice versa)
  - Change in method of invoicing (electronic vs. paper)
  - Change in credit terms
  - Imposition of credit limit/enforcement of existing credit limit
  - Threats to stop shipment
  - Imposition of credit holds
  - Change in mode of delivery (regular mail vs. Federal Express or hand delivery)



# Ordinary Course Of Business Preference Defense – Objective Component/Ordinary Business Terms

- Proof Requirement is Currently Evolving
  - General Standard? Transfer was not so Unusual or Idiosyncratic as to Render it an Aberration in the Relevant Industry – Seventh Circuit *Tolona Pizza* Court of Appeals decision
- Which Industry to Consider?
  - Creditor's industry?
  - Debtor's industry?
  - Industry based on companies similar to creditor selling to companies similar to debtor?
  - General business standards/sound business practice?

# Ordinary Course Of Business Preference Defense – Objective Prong/Ordinary Business Terms

- Includes Range of Industry Terms
  - No need to prove a single set of business terms within an industry
  - Ordinary business terms may vary widely across industries
- Unlike the Subjective Prong, a Creditor's Changing of Business Terms Does not Necessarily Result in the Loss of the Objective Ordinary Course of Business Defense
  - Are new terms frequently used in industry?
  - This is an open issue, without a lot of case law

# Ordinary Course Of Business Preference Defense – Objective Component / Ordinary Business Terms

- Proper Methodology for Determining a Payment's Consistency with Industry Practices is Evolving
- **Example:** *In re Waterford Wedgewood, Inc.* (Bankruptcy Court, Southern District of New York)
  - Whether a payment occurred within one standard deviation of the industry average?
- Contrast with *Hayes Lemmerz International Inc.* (Bankruptcy Court, District of Delaware)
  - Court rejected, as too narrow, expert testimony proffered by trustee limiting industry practice to median range of payments for middle 50% of surveyed companies

# Ordinary Business Terms - Information Sources

- Credit Research Foundation – National Summary of Domestic Trade Receivables
- Risk Management Association
- S&P Capital IQ
- D&B Industry Reports
- CreditRiskMonitor ([www.crmz.com](http://www.crmz.com))
- Trade Associations / Trade Credit Groups
- NACM Expert Witnesses

# Ordinary Business Terms - Information Sources

- American Society of Association Executives ([www.asaenet.org](http://www.asaenet.org))
- Thomson Reuters Expert Witness Services
- Outside Expert Witness Services
- Lay Witness With Either:
  - Specific knowledge of industry practices, or
  - Objective information gained outside subjective experiences as employee of creditor/defendant

# ■ Another Preference Defense

- Delaware Bankruptcy Court Decision: *Quantum Foods*
  - Court approved, apparently for the first time, a creditor's setoff of its unpaid allowed Chapter 11 administrative expense claim for goods sold and delivered post petition to reduce creditor's preference liability on a dollar-for-dollar basis
  - Both creditor's administrative claim and preference claim against the creditor **arose** post-petition satisfying the mutuality requirement for setoff
- Conflicting Holding Rejecting Setoff Preference Defense – *1984 Georgia Steel Holding* – Bankruptcy Court, Middle District of Georgia

# React and Respond To Initial Preference Demand Letter

- DO NOT IGNORE DEMAND
- Request a List of all Checks That Make up the Claim and Copies of Cancelled Checks or Proof of Wire Transfers With Remittance Instructions
- Confirm all Payments Were in Fact Received
  - Check for NSF, return to maker, etc. checks
  - If payments were not actually received, tell the trustee immediately and preference demand may be withdrawn
- Confirm the Date When Each Payment Cleared the Debtor's Bank Account
  - If more than 90 days, there is no preference

# React and Respond To Initial Preference Demand Letter (cont'd)

- **Statute of Limitations:** Has it Expired or is it About to Expire?
- Can the Trustee Actually Sue You?
  - LESS THAN \$6,825 IN THE AGGREGATE, NO preference action may be commenced
    - Trustee will most likely send demand letter anyway
    - If less than \$25,000, the Trustee may have to sue you in the jurisdiction in which the company is headquarters or has a principal place of business, which may give you some negotiating leverage



# Pre-suit Preference Checklist

- Review Defense Strategy With Management
- Develop a Preference Analysis Including the new Value and Subjective Ordinary Course of Business Defenses
- Develop a Game Plan and Negotiation Thresholds
- Consult With Your Bankruptcy Attorney
- Communicate Defenses to Trustee/Debtor
- **NOTE:** Pre-Lawsuit Discussions Might not Happen if it is Close to the Expiration of the Statute of Limitations as the Trustee may not Have Time to Negotiate if the Deadline is Near
- Was the Debtor Insolvent at the Time of the Bankruptcy Filing?
  - Check the bankruptcy schedules
  - Check any financial statements you may have received from the debtor

# Preference Checklist Once Lawsuit Commenced

- Check all Dates
  - Was the lawsuit commenced before the statute of limitations expired
  - Determine your answer deadline (often 30 days)
    - **DO NOT ALLOW A DEFAULT JUDGMENT TO BE TAKEN**
- Try to Obtain an Extension of Time to Answer the Complaint so you can Demonstrate Your Defenses Through a Position Statement in an Effort to Resolve a Potential Lawsuit Without Expensive Litigation
- Timely Contact Your Bankruptcy Attorney if an Answer Extension is not Granted so a Default Judgment is not Taken

# 2019 Bankruptcy Code Amendment: SBRA

- Purpose is to Reduce Costs and Increase Efficiency
- Became Effective February 19, 2020
- Permitted any Business With Maximum Aggregate Debt of \$2,725,625 to File Bankruptcy as a Small Business Chapter 11 Debtor
- The Coronavirus Aid, Relief and Economic Security Act (“CARES” Act) was Enacted on March 27, 2020 and **Sunsets/Expires on March 27, 2021**
  - The maximum aggregate debt limit to qualify as a small business (excluding affiliates and insiders) provided for under the SBRA was increased to \$7,500,000, not less than 50 percent of which is required to arise from the commercial or business activities of the debtor
  - Enables a larger number of small businesses to use Chapter 11 to survive the pandemic and repay their debts without hardship

# ■ SBRA Small Business Provisions

- Small Business Debtors Granted Chapter 11 Protections Subject to a Faster Timeline
- Elimination of Quarterly United States Trustee Fees
- Elimination of Creditors' Committees
- Appointment of Standing Chapter 11 Trustee With Some Oversight Authority to Assist in the Facilitation and Prosecution of a Chapter 11 Plan

# ■ Small Business Debtor Chapter 11 Plan Filing

## ■ Plan Exclusivity

- Only the small business debtor may file a Chapter 11 plan
- The small business debtor has 90 days within which to file its plan
  - The court may extend the 90-day period if the need for the extension is attributable to circumstances beyond the control of the small business debtor
- Unless the Court, for Cause, Orders Otherwise, There is no Requirement for a Separate Disclosure Statement in Connection With a Small Business Chapter 11 Plan

# ■ Small Business-Chapter 11 Plan Confirmation

- Small Business Chapter 11 Plan Can Be Confirmed Notwithstanding Rejection by all Classes of Impaired Claims
- Absolute Priority Rule Eliminated; Equity can Retain Interest Even if Unsecured Creditor Class is not Paid in Full and Rejects Plan if all of a Debtor's Projected Disposable Income Over 3-5 Years is Used to Make Chapter 11 Plan Payments
- Creditors With Administrative Claims Face Risk of Deferred Payment Over the Term of the Plan
- Discharge Limits
  - On confirmation for a consensual plan
  - On completion of plan payments for a non-consensual plan

# ■ Increased Venue Limits On Small Claims

- The Venue Provision That Forces a Trustee or Debtor-in-Possession to Commence Litigation on Smaller Claims in the District Court Where the Defendant Resides (Corporate Headquarters or Principle Place of Business) has Been Increased From \$13,650 to \$25,000
  - Impact: Trustees/debtors-in-possession may be less likely to commence suit on preference and other claims seeking recovery of less than \$25,000
- Does the Increased Venue Limit Apply to Bankruptcy Cases Filed Before SBRA's Effective Date of February 19, 2020?
- Legislation Ignores Prior Conflicting Decisions Over Applicability of Venue Limit to Preference/Other Avoidance Actions

# Preference Changes Per Consolidated Appropriations Act of 2021

- Signed Into Law on December 27, 2020
- New Preference Exception: “Covered Payment of Supplier Arrearages”
  - Payment made in connection with an *agreement or arrangement* made or entered into on and after March 13, 2020 (onset of COVID) between a debtor and a supplier to delay or postpone payment of **amounts due under an executory contract**
  - Payment cannot exceed the amount due under the executory contract before March 13, 2020
  - Does not include fees, penalties and interest in an amount greater than that scheduled to be paid under the contract or which the debtor would owe if the debtor had made all payments on time, and in full, before March 13, 2020
- Exception for landlords, too: “Covered Payment of Rental Arrearages”
- Sunsets on December 27, 2022, but Continues to Apply to Bankruptcy Cases Filed Before December 27, 2022



# Uncertainties Arising From the CAA Preference Changes

- What is an *Arrangement* to Defer or Postpone Payments?
  - How does it differ from an *agreement*?
  - Is a creditor's unilateral decision to defer payment sufficient?
  - Must the creditor announce the deferral? Does it need to be in writing?
  - **Best practice: document and execute forbearance agreement**
- Can the Creditor Defer Payments, While Requiring Payment of Late Charges, Interest or Attorneys' Fees?
  - **Best practice: avoid charging fees, interest, and charges**
- Meaning of Requirement That a "Covered Payment" not Exceed the Amount due Under the Executory Contract Before March 13, 2020?

# Other CAA Bankruptcy Changes

- Extends Small Business Debtor's Time to Perform Under an Unexpired Non-Residential Real Property Lease Based on Financial Hardship Caused by COVID-19
  - Debtor may extend its performance for up to 60 days after the bankruptcy filing
  - Court could grant an additional 60 day extension if the debtor proves a continuing COVID-19 hardship [NEW]
- Extends Time for Debtor to Assume or Reject Non-Residential Real Property Leases to 210 days, Subject to Additional 90 day Extension Without Landlord Written Consent
- Sunsets on December 27, 2022, but Continues to Apply to Bankruptcy Cases Filed Before December 27, 2022

## Other CAA Bankruptcy Changes

- Eligible Small Business Debtors In Chapter 11 can Obtain PPP Loans Only After SBA Determines That Debtors-In-Possession or Trustees are Eligible for PPP Loans
- A Security Deposit or Other Assurance of Payment is no Longer Necessary for Individual Debtors to Prevent Termination of Utility Services (Sunsets on December 27, 2021)
- A Party That Pays the US Government a Customs Duty on Behalf of an Importer is Subrograted to the Government's Priority Status for Customs Duties, Providing a Benefit to Customs Brokers and Forwarders who Frequently pay the Government for Customs Duties on Behalf of Their Importer Clients (Sunsets on December 27, 2021)

# ■ QUESTIONS?

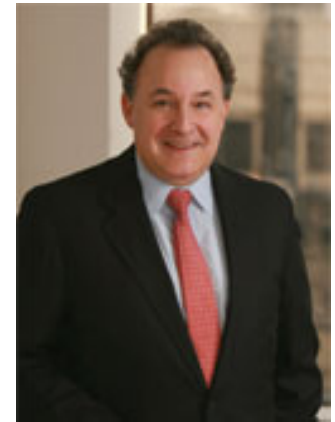
# Bruce S. Nathan

## Partner, Bankruptcy & Restructuring

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Bruce S. Nathan is a partner in Lowenstein Sandler's Bankruptcy, Financial Reorganization & Creditors' Rights Department. Bruce has over more than 35 years' experience in the bankruptcy and insolvency field, and is a recognized national expert on trade creditor rights and the representation of trade creditors in bankruptcy and other legal matters. Bruce has represented trade and other unsecured creditors, unsecured creditors' committees, secured creditors, and other interested parties in many of the larger Chapter 11 cases that have been filed. Bruce also handles letters of credit, guarantees, security, consignment, bailment, tolling, and other agreements for the credit departments of institutional clients.

Among his various legal recognitions, Bruce received the Top Hat Award in 2011, a prestigious annual award honoring extraordinary executives and professionals in the credit industry. He was co-chair of the Avoiding Powers Committee that worked with the American Bankruptcy Institute's Commission to Study the Reform of Chapter 11 and also participated in ABI's Great Debates at their 2010 Annual Spring Meeting, arguing against repeal of the special BAPCPA protections for goods providers and commercial lessors, and was a panelist for a session sponsored by the American Bankruptcy Institute. He is a frequent presenter at industry conferences throughout the country, as well as a prolific author regarding bankruptcy and creditors' rights topics in various legal and trade publications.



### Education

- University of Pennsylvania School of Law (J.D., 1980)
- Wharton School of Finance and Business (M.B.A., 1980)
- University of Rochester (B.A., 1976), *Phi Beta Kappa*

### Bar Admissions

- 1981, New York

# Andrew Behlmann

## Partner, Bankruptcy & Restructuring

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Andrew Behlmann is a partner in Lowenstein Sandler's Bankruptcy & Restructuring Department. Andrew leverages his background in corporate finance and management to approach restructuring problems, both in and out of court, from a practical, results-oriented perspective. With a focus on building consensus among multiple parties that have competing priorities, Andrew is equally at home both in and out of the courtroom, and he has a track record of turning financial distress into positive business outcomes. Clients value his counsel in complex Chapter 11 cases, where he represents debtors, creditors' committees, purchasers, and investors.

Andrew writes and speaks frequently about bankruptcy matters and financial issues. Before becoming a lawyer, he worked in senior financial management at a midsize, privately held company.



### Education

- Seton Hall University School of Law (J.D. 2009), magna cum laude; Order of the Coif
- University of Missouri-Saint Louis (B.S. 2005), Business Administration-Finance and Accounting; *Beta Gamma Sigma*

### Bar Admissions

- New Jersey

# Michael Papandrea

## Associate, Bankruptcy & Restructuring

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Michael Papandrea is an associate in Lowenstein Sandler's Bankruptcy & Restructuring Department. Michael provides counsel to debtors, creditors' committees, individual creditors, liquidating trustees, and other interested parties with respect to corporate bankruptcy and creditors' rights matters, including bankruptcy-related litigation.

Reliable and efficient, Michael is appreciated for his innate ability to effectively apply and communicate his understanding of the law and general business principles with respect to complex issues, both while providing advice to clients and while aggressively advocating on their behalf. Michael works tirelessly to understand clients' needs and provide practical solutions that are reasonable, balanced, and favorable to the clients he serves.

Michael takes pride in his commitment to the community and provides pro bono representation to individuals and a nonprofit organization regarding bankruptcy and foreclosure-related matters.



### Education

- Rutgers Law School (J.D. 2014), *Rutgers Journal of Law & Public Policy*
- The College of New Jersey (B.S. 2010), Criminology

### Bar Admissions

- New York
- New Jersey

# Recent Publications

- February 2021  
[A Primer on Selling Bankruptcy Trade Claims](#), *Business Credit*  
Bruce S. Nathan, Scott Cargill
- January 2021  
[Reclamation Rest in Peace? The Eighth Circuit Will Soon Weigh In](#), *Business Credit*  
Bruce S. Nathan, Michael Papandrea
- November/December 2020  
[Bankruptcy Court Chooses Dismissal Over Conversion Based on the Support of the Debtor and All Key Creditors](#), *Business Credit*  
Bruce S. Nathan, Michael Papandrea
- October 2020  
[Critical-Vendor Status: An Additional Preference Defense?](#), *ABI Journal*  
Bruce S. Nathan, Scott Cargill, John P. Schneider
- September/October 2020  
[Critical Vendor Treatment May Not Absolve Trade Creditors from Preference Risk](#), *Business Credit*  
Bruce S. Nathan, Michael Papandrea
- July/August 2020  
[Claims Buyers Beware: Your Shiny New Claim May Face Avoidance Risk](#), *Business Credit*  
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