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Legal Spotlight

Bankruptcy Preferences – 11 U.S.C. 547

Tips for Construction Professionals

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Contractors whose clients have ended up in bankruptcy face unique problems and risks that must be managed. One of those risks is an action seeking to recover alleged preferences under 11 U.S.C. § 547.

What are preferences?

At a high level, 11 U.S.C. § 547 may allow a bankruptcy trustee to claw back payments contractors have received—even if the work was performed and the payments were made pursuant to the parties' contract.

Pursuant to 11 U.S.C. § 547(b), a trustee for a bankruptcy estate may avoid any transfer from a debtor, provided the trustee proves, by a preponderance of the evidence, the following elements:

(1) the transfer is made to or for the benefit of a creditor;

(2) the transfer is made for or on account of an antecedent debt owed by the debtor before such transfer was made;

(3) the transfer was made while the debtor was insolvent and on or within 90 days before the date of the filing of the petition; and

(4) the transfer 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 title 547.

Importantly, if any transfer is made to an insider – defined in Section 101(31) of the bankruptcy code to include family members and officers and directors of a corporate debor—the preference period is increased to one year instead of ninety days.

What types of payments are covered?

Almost any type of payment made during the preference period can qualify as a preference. If a payment was made pursuant to an invoice, it is made on account of an antecedent debt for the benefit of a creditor. Thus, if the transfer was made during the preference period while the debtor was insolvent, a trustee may argue that the transfer is voidable as a preference because it allowed the transferee the ability to receive more than it would have in a Chapter 7 proceeding.

Why do I care?

Preference actions give the bankruptcy trustee the ability to demand return of payments received—even if the payments were received lawfully, in accordance with your contract,

…11 U.S.C. § 547 allows a bankruptcy trustee to claw back payments….

and for materials or labor you supplied. This could lead to the disastrous result of being forced to return payments received, even after you have already paid your subs, vendors, and suppliers.

Fortunately, for contractors, there are several commonly used and applied defenses that may protect against this outcome.

Mechanics' Lien Defense

Under Colorado law, materialmen who furnish or supply labor or materials are entitled to a statutory lien to the extent of the entire contract price or, if there is no contract, for the value of the improvements made to the property. C.R.S. § 38-22-101.

Typically, a mechanic's lien is perfected by serving notice of an intent to file a lien statement and thereafter recording the lien statement in accordance with applicable Colorado statutes. In that event, the mechanic's lien claimant would be a secured creditor and would be entitled to payment of its claim out of the collateral to which the lien attached.

However, what happens when the contractor has been paid in full and thus never perfected a lien? In that situation, a trustee could argue that the contractor is simply an unsecured creditor and its receipt of payment constituted an avoidable preference.

Fortunately, the Tenth Circuit has considered this issue and held that payments to materialmen do not constitute avoidable preferences where: (a) at the time of payment, the materialman could have perfected a mechanic's lien had the materialman not been paid; and (b) the lien, if perfected, would not have been avoidable by the trustee under 11 U.S.C. § 545. *In re Electron Corp.*, 336 B.R. 809, 813 (10th Cir.BAP 2006).

In finding that the payments made to the materialman were not avoidable preferences, the Tenth Circuit noted that 11 U.S.C. § 547(b)(5)(B) requires the Court to evaluate a creditor's status as if the transfers had not taken place. *Id.* at 813. The Court then noted that, had the materialman perfected its statutory lien, the materialman would have received full payment of his claim in a hypothetical Chapter 7 case because the value of the collateral by which the claim would have been secured was sufficient to cover the claim. *Id.*

Since the payments received by the materialman did not allow the materialman to recover more than he would have recovered in a hypothetical Chapter 7 case, the Court held that the payments were not avoidable preferences as a matter of law. *Id.* The panel reasoned that "as a policy matter, it could not hold otherwise because '[h]olders of inchoate statutory liens would be faced with an unreasonable Hobson's choice between accepting payment or taking the commercially unreasonable step of declining payment in order to perfect an inchoate statutory lien.'" *Id.* (quoting *In re 360Networks (USA) Inc.*, 327 B.R. 187 (Bankr.S.D.N.Y.2005)).

The Tenth Circuit's decision agreed with the reasoning of a Southern District of New York bankruptcy case, *In re 360Networks (USA) Inc., supra.*, which dealt with a similar fact pattern.

In 360Networks, the bankruptcy court held that "payment in satisfaction of an inchoate lien is not an avoidable preference where perfection of the lien would not have been avoidable." *Id.* at 189.

In so holding, the Court reasoned that the payment a materialman receives "should not be less secure than the lien which could have secured it." *Id.* at 190 (quoting *Ricotta v. Burns Coal & Bldg. Supply Co.*, 264 F.2d 749, 750-751 (2d Cir.1959). This approach is in line with that taken by Ninth Circuit case, *Greenblatt v. Utley*, in which the Court held that an inchoate lien, discharged by payment within the preference period but prior to the lien's perfection, may not be avoided as a preference. 240 F.2d 243 (9th Cir. 1956). While *Greenblatt* is a pre-bankruptcy code case, the ruling has been applied and cited in cases decided under the code. *See, e.g., In re*

Larsen, 2008 WL 4498890 (Bkrtcy.D.Idaho, 2008).

In short, Contractors may be able to rely on the above authority to protect themselves against preference claims seeking to claw back payments they have received.

Ordinary Course of Business Defense

The 'ordinary course of business' exception to preferential transfers is codified by statute at 11 U.S.C. § 547(c)(2), which provides a trustee may not avoid 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;

Analyzing the above language, the Tenth Circuit has held that the ordinary course of business exception contains a subjective test and an objective test. *In re Allied Carriers' Exchange, Inc.*, 375 B.R. 610, 616 (10th Cir.2007).

Ordinary Course of Business: Subjective Test

The subjective test examines whether the transfers at issue were "ordinary as between the parties", while the objective test examines whether the transfers were "ordinary in the industry" or under "ordinary business terms." *Id.* at 616. The party asserting this defense bears the burden of proving that the transfers fall within either subsection (A) or subsection (b) by a preponderance of the evidence, and the defense must be narrowly construed. *In re Furr's Supermarkets, Inc*., 373 B.R. 691, 705 (10th Cir.2007); *see also*, 11 U.S.C. § 547(g).

In order to determine whether the payments meet the subjective test, the Tenth Circuit has held that "[C]ourts must consider the four following factors by comparing pre-preference period transfers with preference period transfers to determine if the transactions meet the criteria of the subjective test:

> (1) the length of time the parties were engaged in the transaction at issue;
>
> (2) whether the amount or form of tender differed from past practices;
>
> (3) whether the debtor or creditor engaged in any unusual collection or payment activity;
>
> (4) the circumstances under which payment was made.

Id. (citing *Payne v. Clarendon Nat'l Ins. Co. (In re Sunset Sales, Inc.)*, 220 B.R. 1005, 1020 (10th Cir. BAP 1998).

Ordinary Course of Business: Objective Test

In the context of analyzing the objective test set forth in § 547(c)(2)(B), the Tenth Circuit has stated that "ordinary business terms" means terms that are used in usual or ordinary situations. *In re Allied Carriers' Exchange, Inc., supra*, 375 B.R. at 617. Since the "purpose of the ordinary course exception is to leave undisturbed normal financing relations…", a payment will satisfy the objective test when it is a type of payment "that creditors and debtors use in ordinary circumstances, when debtors are healthy." *In re Meridith Hoffman Partners*, 12 F.3d 1549, 1553 (10th Cir.1993).

The central issue, therefore, is whether a payment favors a certain creditor or encourages a race to 'dismember' the creditor, thereby hastening the creditors decline into bankruptcy. *Cf. id*.

Contemporary Exchange for New Value Defense

Pursuant to 11 U.S.C. 547(c)(1), a trustee may not avoid a transfer 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….

Contractors may be able to rely upon this defense by arguing that their release of their inchoate lien rights constitutes a contemporaneous exchange for new value.

In an analogous case, *In re George Rodman, Inc.*, the Tenth Circuit held that a materialman's release of his lien against an oil well in exchange for payments from the well owner constituted a contemporaneous exchange for new value. 792 F.2d 125 (10th Cir. 1986). This ruling was clarified and explained in greater detail in *In re Robinson Bros. Drilling, Inc.*, in which the Tenth Circuit held that, where a creditor releases a lien in exchange for a payment of equivalent value from the debtor, the payment constitutes a contemporaneous exchange for new value that cannot be avoided by the trustee. 877 F.2d 32, 33 (10th Cir. 1989).

In finding the releases constituted new value, Courts reason that, where a lien is released that is equivalent to the full amount of the payment by the debtor, the bankruptcy estate is not diminished by the transfer because the creditor would have been paid anyway. *Id.* The following cases have found that a release of inchoate lien rights may constitute 'new value' for the purposes of proving §547(c)(1)'s defense. *See, e.g., In re Charwill Const. Inc.*, 391 B.R. 7 (Bkrtcy.D.N.H.2007); *see also In re J.A. Jones, Inc.*, 361 B.R. 94 (Bkrtcy.W.D.N.C.2007).

Conclusion

Allegations of preferential transfers under 11 U.S.C. 547 can have serious and devastating consequences for contractors. Fortunately, there are tools at your disposal to try to mitigate the risks of a preference action on the front end. These include properly preserving your lien rights, ensuring that invoices are regularly submitted and payments are regularly received in the ordinary course of business, and paying attention to the financial health and solvency of your clients. Should you find yourself in a preference action, there are tools to proactively defend against the claim and protect your valuable business assets.