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Trustee Talk

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A Trustee's Guide to Preference Portfolio Monetization

Virtually every company seeking bankruptcy protection will have made payments or transferred value within the 90 days prior to the bankruptcy case's commencement. This holds true for chapter 7 and liquidating chapter 11 cases, both of which will require the services of a seasoned trustee to administer the case. This begs the question: What, if anything, is unique about the pursuit of a preference portfolio in a chapter 7 or chapter 11 liquidation?

The most obvious answer is the likelihood that recovery of preferential transfers might be a material component of any funds distributed to creditors on account of allowed claims. With this heightened focus on preferences as an asset class, taking appropriate action on preferences is even more important for a trustee. With this in mind, this article provides a list of some steps for a trustee to follow when evaluating and managing a preference portfolio.

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Step 1: Hunt and Gather

The key to a successful preference-recovery program is securing the necessary information early in the process. Grab all of the information you can as early as possible; do not be shy. In addition to securing the debtor's physical documents, the trustee must ensure that all digital information is gathered and/or maintained. This includes gaining access to the accounting system(s) — including all user accounts and passwords, taking control of all custodial email accounts, discontinuing all email-deletion protocols, and gaining access to/control of all serve environments, among other things. Depending on the status of the liquidating entity, a litigation-hold email should be sent to all employees, professionals and other agents of the debtor to ensure that no documents are disposed of without trustee approval.

Not only will you be taking testimony from the debtor through either the individual debtor or the debtor's principal(s) under the § 341 process, you should actively seek any information and/or documentation that exists regarding any known accounts or data-saving platforms that perhaps have not been disclosed in the filed schedules. This is especially true where debtor corporate ownership was not actively involved in the pre-petition, prebankruptcy business operations.

In addition, bookkeepers or in-house accountants (whose privilege, if any, now runs to the trustee) are keenly aware of operating or repository accounts that have been closed and not necessarily disclosed in the schedules. The trustee will also need to gain access to all company bank accounts, especially those from which distributions during the 90-day preference period were made. Contacting these banks to obtain bank statements and copies of all canceled checks is the first step, but banks will often require a subpoena to proceed with gathering and providing this information.

Step 2: Trust, but Verify

The debtor's accounting system might lie to you, particularly where the reason for bankruptcy is fraud by the debtor. Even where there is no fraud, it might tell only part of the story due to the stress put on the accounting group and as the company slides inexorably toward a bankruptcy filing. Suffice it to say, the books might be incomplete and/or unreliable. For this reason, it is critical to verify all payments listed in the accounting system to the company's bank statements and, ideally, copies of canceled checks or specific wire/ACH detail information.

Doing so will give confidence that the payments being sought for recovery were made, and in certain situations, this process may lead to additional pay-

ments that are not reflected in the accounting system. This is especially critical where the debtor's own accounting system may reflect outbound transfers/payments pre-petition, but, for a variety of reasons, those transfers or payments were not completed, and the uncompleted transaction was not recorded in the debtor's books and records. This can be a common occurrence in the fiscally distressed period leading up to a bankruptcy filing. Thus, what appears to be an actionable transfer avoidance under § 547 or 548 (or even § 544) might not be eligible for clawback.

Step 3: Is the Juice Worth the Squeeze?

Analysis of the key statutory defenses is crucial to understanding the true potential value of a preference portfolio. The answers given in this analysis could lead a trustee to forego a pursuit of certain preferences or all preferences where the cost to pursue — even with contingency fee counsel — is insufficient to justify the process. The trustee and its professionals should process all verified preference period payments through an analytical model that accounts for the following: (1) paid and unpaid subsequent new value; (2) ordinary course of business; and (3) contemporaneous exchange of new value. This model should account for data anomalies such as credits, refunds and prepayments, while also providing differing approaches such as utilizing days-to-pay and days-late methodologies to the ordinary-course-of-business defense analysis.

In addition, seasoned preference professionals will be able to assist the trustee in identifying the types of payors that may have complete nonstatutory defenses, such as retained professionals, payroll vendors, insurance financiers/brokers/carriers, benefits providers, utilities, governmental entities and landlords, among others. Drilling down on the net value of the preference portfolio will position the trustee to make informed decisions about the pursuit of the portfolio and will enable the trustee to better manage expectations regarding such value. It also will ensure that the trustee has satisfied the necessary diligence requirements set out in the Small Business Reorganization Act of 2019 (SBRA), which requires the debtor to assess "known or reasonably knowable affirmative defenses," a condition precedent to moving forward with a preference action.

Lastly, this analysis may also identify "low-hanging fruit" in the form of defendants who received a substantial transfer but appear to have obvious statutory defenses. These cases should be pursued early in the process. Timeliness and careful analysis of data capture for the trustee's avoidance portfolio review is especially critical where the economic conditions (such as the COVID-19 pandemic global shutdown and business operations losses) may directly affect the trustee's decision to pursue, or to what lengths a trustee should pursue, the *collection or collectability* of an avoided transfer.

Step 4: Supply and Demand

Once a trustee determines that there are viable preferences to pursue (*i.e.*, supply), the next step is to demand the return of what was transferred. Demand letters typically include a discounted offer and a simplified settlement agreement to incentivize efficient settlements. Nonetheless, demand letters also serve as an open invitation to settlement discussions, inviting the recipient to demonstrate what (if any) statutory or other defenses they may have to the preference claim. Where data is provided in support of statutory defenses, this information should be evaluated through the debtor's analytical model to verify accuracy and to understand the strength of the defensive position asserted.

Lastly, notwithstanding the enhanced diligence requirements of the SBRA, § 547(g) still places the burden of proof of all statutory defenses on the demand letter recipient (*i.e.*, the "payee" of the preference). A best-practice approach is to draft and utilize several versions of the demand letter. Even after transfer and avoidability data has been thoroughly exhausted to the best of the trustee's and his/her professionals' abilities, there are often circumstances where the trustee still is not locked in on avoidability strength of the transfer to merit an avoidance complaint. This situation probably merits softer, more "watered-down" demand letter language that is more in the vein of confirmation or request for defense than it is strict legal demand language.

Step 5: When in Doubt, Fight It Out

Litigation is typically the last resort, reflecting the point at which the parties have reached an impasse. This is not always the case in pursuing a preference portfolio, particularly one with hundreds or thousands of preference matters. Rather, the filing of a complaint might be necessary, simply because the statute of limitations is fast approaching. It may also result from inaction by the payee in responding to the demand letter.

Not surprisingly, the filing of a complaint and service of a summons sharpens the focus of those from which you seek to recover a preference. To ensure that the parties can reach an amicable resolution post-complaint without incurring unnecessary litigation expense, it is best practice to build in a healthy period to allow the parties to engage in additional settlement discussions before any litigation deadlines kick in.

In this regard, tolling agreements can be the trustee's best friend. If the putative avoidance defendant is represented by counsel, but data retrieval for full defense is slow in coming, opposing counsel will see the advantage of delaying the need to respond to a filed trustee's avoidance complaint due to a looming statutory run in order to further retrieve defense data and discuss settlement options with the trustee. It is also usually best — typically via a procedures motion — to require all motion practices and discovery to occur only after completion of mediation. Doing so maximizes the likelihood of settlement while limiting litigation-related expenses on both sides.

Other Considerations: Non-U.S. Payees and Defaults

A decision to pursue the recovery of preferences from non-U.S. payees requires an additional level of analysis, considering the time and cost of pursuit, and the likelihood of collection (among other things). For example, service of process on foreign defendants via Hague Convention procedures can be costly and take potentially considerable time

to receive confirmation that service was effectuated (*i.e.*, months to years, depending on the country).

In addition, defendants in foreign sovereignties that are not signatories to the Hague Convention are almost unservable, at least to the point where achieving that basic element of the avoidance litigation procedure is impractical for the trustee depending on the amount in question. Even after confirming service of process, collectability on account of a successful preference action is often hard to assess. That said, if a preference payee has an administrative claim or general unsecured claim that has value, the trustee may pursue it solely for purposes of achieving a waiver of such claims, effectively.

Typically, default judgments are not worth much. Collecting on a default judgment requires an investigation into available assets and domestication of the judgment in the jurisdiction where those assets are located, then execution of the judgment via attachment, liens or other available remedies. The costs associated with this process (*e.g.*, local counsel fees, filing fees, asset investigation costs, etc.) can make pursuing collection on a portfolio of default judgments prohibitive. This is doubly so if attempting to secure collection in a foreign jurisdiction. Unfortunately, given these costs and the speculative nature of successful collection, the sale of a default-judgment portfolio also does not typically result in a windfall for the trustee, as the portfolio will likely sell for only pennies on the dollar.

The uncollected default judgment often becomes part of the larger, more universal and general remnant sale that can be considered and pursued by the trustee near the end of the estate's administration. One exception to the somewhat bleak view of a default-judgment portfolio is the disallowance of claims. If a preference defendant who defaults holds a claim against the estate, securing a default judgment is tantamount to the final disallowance of that claim. If the claim at issue asserts administrative or priority status, the disallowance also results in a dollar-for-dollar benefit to the estate.

Conclusion

Trustees can efficiently and successfully monetize preference portfolios for chapter 7 and chapter 11 liquidations by following best practices and some essential steps in the process. In doing so, they can maximize recoveries and value for the estate and its stakeholders that are well worth the effort. **abi**

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