THE BANKRUPTCY STRATEGIST

APRIL 2019

Preference Attacks To Recover Prepetition Compensation Paid to Consultants of Troubled Companies

By Paul A. Rubin and Hanh V. Huynh

Employees of a troubled company who stay on as consultants to assist in liquidating its assets or preparing the company for a bankruptcy filing may later be disappointed to face claims to claw back their prepetition compensation. Ironically, those who made it possible for the company to maximize the recovery on its assets or to file for bankruptcy, may be sued by a bankruptcy trustee for the return of monies received within 90 days of the bankruptcy filing as preferential payments.

While trade vendors and other unsecured creditors may be familiar with such claims, there are nuances to preference litigation against prepetition consultants that add layers of complexity not generally present in typical preference actions. While the same defenses against other preference claims are available to prepetition consultants, application of the defenses in this context requires consideration of certain factors that are not often scrutinized in the garden variety preference case.

Understanding the particular issues affecting employees/consultants is necessary for developing the best approach to prosecute or defend this type of claim. Familiarity with these issues could help minimize the risk of future litigation if taken into consideration by a consultant *before* he or she decides to enter into a consulting agreement with a troubled company that is contemplating a bankruptcy filing.

Preference Claims and Defenses

Generally speaking, to recover a payment as a preference under section 547 of the Bankruptcy Code, the plaintiff must establish that it was made to or for the benefit of the creditor, on account of an antecedent debt owed by the debtor to the creditor before the transfer was made, while the debtor was insolvent, within 90 days of the bankruptcy filing (or within one year if the payment was made to an insider), and that the payment enabled the creditor to receive more than it would under a Chapter 7 case if the transfer had not been made.

A defendant in a preference action may raise certain defenses that are relevant here. A trustee may not recover a transfer: 1) to the extent the transfer was intended to be a contemporaneous exchange for new value (*see* 11 U.S.C. § 547(c)(1)); 2) that was made in the ordinary course of business to pay a debt incurred in the ordinary course of the debtor's business (*see* 11 U.S.C. § 547(c)(2)); or 3) to the extent the transfer was in exchange for subsequent new value to the debtor (*see* 11 U.S.C. § 547(c)(4)). The defendant transferee has the burden to prove these defenses.

Analyzing Preference Claims Commenced Against Prepetition Consultants

A preference defendant should never assume that a trustee has satisfied his or her burden to establish a *prima facie* case to avoid and recover preferential payments. Each element should be scrutinized by

counsel as appropriate. But the former consultant/defendant should understand that, in these situations, the *prima facie* elements of a preference claim are usually present. Realistically, however, consulting fee payments often have: 1) been made from funds of the debtor, 2) been received by the consultant on account of an antecedent debt (the obligations under the consulting agreement), 3) been made while the company was insolvent (which is presumed to be the case in the 90-day preference period), and 4) allowed the recipient to receive a greater distribution than he or she would have otherwise received in the Chapter 7 case if the payments had not been made.

Accordingly, most preference litigations against former consultants will likely focus on the defenses that may be available to the consultant. While each case is unique, litigants in preference actions concerning payments of consulting fees would be well-served to consider the following.

Contemporaneous Exchange for New Value and Subsequent New Value

For purposes of the contemporaneous exchange for new value defense under section 547(c)(1) of the Bankruptcy Code, courts have interpreted the term "new value" to include the continued services of employees. Payments to employees may be construed as "contemporaneous" so long as the employer-debtor keeps current by paying the employees' salaries and benefits when due. *See In re Dewey & LeBoeuf LLP*, 2014 WL 4746209 (Bankr. S.D.N.Y. Sep. 23, 2014); *In re 360networks (USA) Inc.*, 338 B.R. 194, 204-05 (Bankr. S.D.N.Y. 2005).

Moreover, there is an initial presumption that, where a contract exists, the contractual rate is the reasonable value of the goods or services provided to the estate. The presumption is viable unless the plaintiff introduces convincing evidence to the contrary. *See In re Bethlehem Steel Corp.*, 291 B.R. 260 (Bankr. S.D.N.Y. 2003); *In re Globe Metallurgical, Inc.*, 312 B.R. 34 (Bankr. S.D.N.Y. 2004). This rebuttable presumption has been applied in the context of payments made under a consulting agreement with a former executive of the debtor. *See In re Enron Corp*., 357 B.R. 32 (Bankr. S.D.N.Y. 2006).

Similarly, with respect to the subsequent new value defense under section 547(c)(4), employees are presumed to have provided services equal to their wages. *See Jones Truck Lines, Inc. v. Central States, Southeast and Southwest Areas Pension Fund (In re Jones Truck Lines, Inc.)*, 130 F.3d 323, 328 n.4 (8th Cir. 1997) ("Absent contrary evidence the value of employee services is presumed equal to the wages and benefit the employer contracted to pay"). *See also In re Nomus-North Carolina, Inc.*, 2004 WL 574510, at 4 (Bankr. M.D.N.C. Mar. 2, 2004); *In re NETtel Corp.*, 319 B.R. 290, 295 (Bankr. D.C. 2004); *In re Molten Metal Tech., Inc*., 262 B.R. 172, 176 (Bankr. D. Mass. 2001); *In re Pulaski Highway Express, Inc.*, 57 B.R. 502, 510 (Bankr. M.D. Tenn. 1986). Notably, the Eighth Circuit reasoned that "[i]t would not encourage employees to stick with a troubled business if their current wages and benefits could later be attacked as preferential on the ground that their labor was not worth what the employer agreed to pay." *Id.* At least one court, however, has declined to apply a rebuttable presumption that the value of services provided by a consultant under a consulting agreement to wind down the debtor company was equal to the payments received under the agreement. *See In re Dearborn Bancorp., Inc.*, 583 B.R. 395, 421 (Bankr. E.D. Mich. 2018).

With the foregoing in mind, a preference defendant being sued by a bankruptcy trustee for the return of payments made under a consulting agreement should assess evidence, including the language of the consulting agreement, to demonstrate that payments made under the consulting agreement were intended to be a contemporaneous exchange for the services to be provided thereunder. While there may be a presumption that the services provided by the consultant are commensurate with the payments received under the consulting agreement, the presumption is rebuttable. The defendant should be prepared to demonstrate the value of the services performed. Each service performed by the consultant and every benefit conferred upon the company should be carefully documented, because the outcome of a future litigation could turn on the value of the services the consultant provided.

Ordinary Course of Business

The ordinary course of business defense under section 547(c)(2) of the Bankruptcy Code requires the defendant to demonstrate that 1) the alleged preferential transfer was in payment of a debt incurred in the ordinary course of the debtor's and the defendant's business or financial affairs, and 2) the transfer was either A) made in the ordinary course of business (known as the "subjective" prong), or B) made according to ordinary business terms (known as the "objective" prong). Under the subjective prong, the defendant must establish a baseline of historical payment practices between the debtor and the defendant for the period preceding the preference period, and then compare each alleged preferential transfer to the baseline dealings between the parties.

A consultant being sued for preferences under a consulting agreement should compile information regarding historical payment information to create a baseline of business dealings. In this context, the data should be straightforward and there should not be much deviation in the debtor's history of payments of wages and salary to the consultant/former employee. To the extent that a consulting agreement simply continues the prior terms of payments that the employee received, the ordinary course of business defense may be easier to demonstrate.

An argument could be raised that any payments made under a consulting agreement involving the wind down of the debtor was not made to pay a debt incurred in the ordinary course of business, because the wind down of the company is *per se* not in the ordinary course of business. *See In re Dearborn Bancorp., Inc.*, 583 B.R. at 408. On the other hand, for purposes of the ordinary course of business defense, the term "ordinary business terms" is widely understood to encompass customary terms and conditions used by other parties in the same industry as the troubled company facing similar problems. *See In re Roblin Indus., Inc.*, 78 F.3d 30, 39 (2d Cir. 1996).

Potential Strategies to Minimize the Risk of Liability

By understanding the litigation risks, an employee of a troubled company who decides to enter into a consulting agreement with the company to provide services in connection with the winding down of the company and to prepare the company for a bankruptcy filing should consider taking certain measures to minimize the risk of preference exposure.

Forego the Consultant Arrangement

If 1) the company is not seeking to terminate the employee's employment, 2) the employee is amenable to continuation of the terms of his or her employment for the purposes of winding down the company, and 3) the employee is not seeking to negotiate additional benefits under a consulting agreement, it may be prudent for the employee to forego the consulting agreement altogether. Arguably, any payments received would simply be continuation of ordinary compensation, for which the employee and debtor presumably will have an established history so that an ordinary course of business defense could be more easily demonstrated.

Get Paid In Advance

The consultant should seek payment upfront, before providing the consulting services. Payments made by the company before the company is obligated to make them cannot be clawed back as preferences because they are not made on account of an antecedent debt.

File the Company's Bankruptcy Case More Than 90 Days After Payments Are Received

If the consultant is not an insider of the company, he or she can seek to schedule the filing of the company's bankruptcy case for to a date that is more than 90 days after the receipt of payments under a

consulting agreement. Only payments made in the 90-day preference period may be recovered as preferences from a non-insider defendant. But in affecting the timing of the bankruptcy filing, the consultant must be careful not to put his or her personal interests ahead of those of the company, because the consultant does not want to be exposed to a breach of fiduciary duty claim.

Receive Payments More Than 90 Days In Advance of a Bankruptcy Filing

Alternatively, if the date of the filing of the bankruptcy case has been fixed, the consultant should attempt to receive payment more than 90 days before the scheduled filing date. But bear in mind that unforeseen events may compel a bankruptcy filing earlier than anticipated.

Get the Details In Writing

If the employee is being terminated and his or her continued services are to be provided as a consultant, the terms of the consulting arrangement should be formalized in a written agreement to help establish the existence of an arms' length agreement. The agreement should include provisions specifying tasks that the consultant is being engaged to perform in addition to a catch-all clause that would cover whatever additional (unspecified) services the company may request of the consultant. Inclusion of detailed provisions in the agreement specifying tasks to be performed may help demonstrate that the disputed payments were intended to be contemporaneous exchanges for the provision of those services.

Do the Work

Lastly, the consultant should perform the services as provided in the agreement. Some consulting agreements might not condition payments upon the performance of any services. Even in the absence of specific contractual service requirements, the consultant should provide appropriate, valuable services that may justify receipt of payments that could become subject to a preference attack.

While the strategies described above do not guarantee that preference litigation will be avoided, they can help shape the contours of future litigation by a bankruptcy trustee and place the consultant in a better position to achieve a more favorable settlement.

*****

Paul A. Rubin is the founder of Rubin LLC, a law firm focusing on business bankruptcy, workouts and restructurings, and related litigation. **Hanh V. Huynh** is associated with the firm.