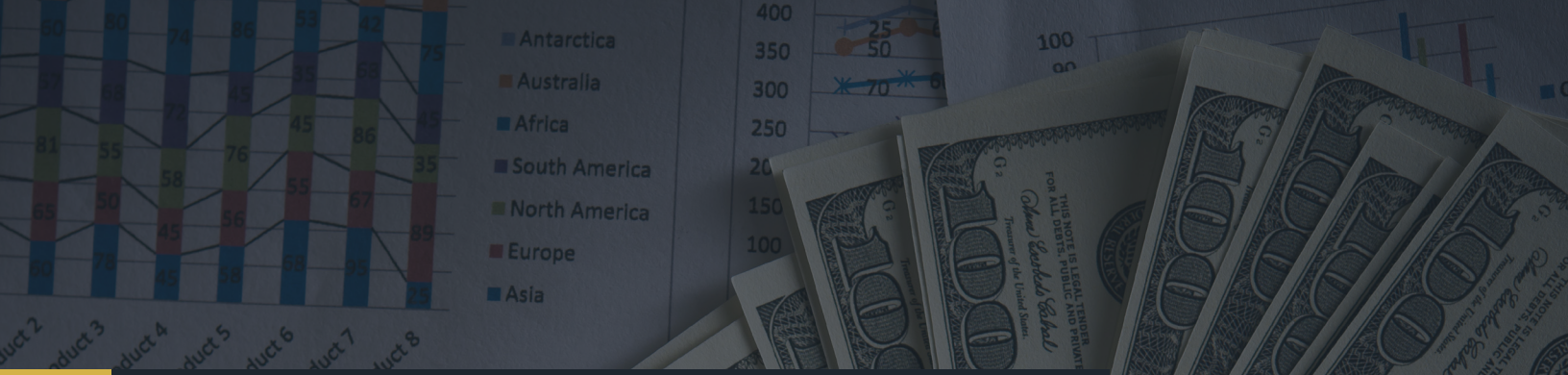

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A TRUSTEE'S GUIDE TO MAXIMIZING PREFERENCE RECOVERIES

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Preferences Are More Valuable Than You Think.

Our experience is that by using a data driven approach coupled with specialization and systems, preference litigation often generates millions of dollars for the estate. Successfully prosecuting preferences can make the difference between distributing pennies and a significant distribution to creditors. In this white paper, we share our insights and systems employed to ensure maximum preference recovery and collection, thereby producing meaningful value for estates and creditors.

Don't Trust the Debtor's SOFA

One of the first places to look in assessing potential avoidance claims is the debtor's response to question 4 of the Statement of Financial Affairs. An exhibit is typically attached to the SOFA (some more detailed than others) identifying transfers made within the applicable 90-day and one year preference periods.

While the response to SOFA question 4 is a good starting point — beware. The individuals preparing the SOFA don't have the same motivations as trustee's prosecuting avoidance actions. SOFAs are more often than not prepared from accounting records and reports that rely upon check cut date rather than clear date. As a result, the SOFA can understate the total amount of preference claims, as some checks cut prior to the preference period inevitably clear during the preference period. In addition, the debtor's records are not always accurate. So it is possible that transactions are not reflected in the accounting records relied upon when preparing the SOFA. To be clear, a debtor need not be seeking to conceal transfers to omit potential preference payments from the SOFA; it is often inadvertent.

Number 1

To address this issue, the best practice is to obtain copies of the debtor's bank statements and reconcile the statements to the debtor's accounting records. Taking this step ensures that all potentially avoidable transfers are identified.

While this can be a time-consuming process, it yields real benefits. For example, in a recent case, we identified a number of additional transfers that were the direct result of the SOFAs having been prepared based off the check cut date rather than clear date. One such omitted claim was for over $500,000 for which there was no defense. Simply relying on the SOFA would have meaningfully reduced the estate's recovery.

Conducting the Initial Review

As noted above, the best practice is to review the debtor's bank records to ensure that all potentially avoidable transfers have been identified. Once the transfers have been identified, it is time to determine the potential exposure for each transferee.

As we all know, the state of a debtor's records varies from case to case. Some debtors have excellent records from which relevant data can be easily extracted. Others don't. Typically, in conducting an initial claim analysis, you will want accounting data showing invoices issued by the transferee to the debtor. This is a proxy for new value, though don't rely too heavily on invoice date, as it is not always the date new value is provided. You will also want accounting data reconciling transfers to invoices. This is helpful in assessing potential ordinary course defenses. If this information is available, you should be able to develop a reasonable estimate of what likely liability looks like on each potential preference claim.

Doing this analysis upfront serves a few purposes. First, it ensures that you have complied with the due diligence requirement now contained in Section 547(b). In addition, it helps uncover patterns in the debtor's case. By conducting an upfront analysis, you can spot common issues that are present among all or a specific type of transferee. For example, it may become clear that the debtor's payment performance generally began to erode during a particular period of time. But perhaps most importantly, having this information prepared ahead of time makes you far more effective in settlement negotiations.

Considerations in converted chapter 11 cases

If a case is a converted chapter 11, you should consider the impact certain types of orders entered during the chapter 11 case might have on potential liability. This includes critical vendor orders and orders allowing Section 503(b)(9) claims, which can impact application of subsequent new value. Orders authorizing the assumption of executory contracts should also be considered, as the assumption of an executory contract may serve as a complete defense. There are also often releases of preference liability contained in cash collateral orders.

The Way You Send Demand Letters Impacts Recovery

The purpose of a demand is to engage the opposing party in discussions aimed at expeditiously resolving the preference claim. This purpose should be kept in mind when deciding where to send a demand and what to include in the demand.

A demand is only effective if it produces a response from the transferee. Without a response, there is no chance of resolving the claim without litigation. To maximize response rates, it is crucial that the demand letter be sent to someone that has authority to resolve the claim or that will ensure that the demand makes it to someone who does. Sending the demand to the addresses identified on the creditors matrix will produce dismal results. While it can be time consuming, researching the best contacts for the demand letter is invaluable to resolving preferences expeditiously and without litigation.

Likewise, a demand is only effective if the response is directed towards resolution of the claim. Demand letters should be drafted in a way to make clear that you are willing to proceed to litigation if necessary, but should offer to resolve the claim before litigation is commenced. If there are substantiated defenses based on your initial analysis, the offer conveyed in the demand should take those defenses into account. If not, the demand should clearly spell out the information that you would find helpful in resolving the claim. That way, when the response comes, it is more likely to contain the information necessary to evaluate the claim and make a more precise settlement offer.

Number 2

Spend time at the outset of a case investigating where to send demand letters. Basic internet research can help identify officers, general counsel (if the company is of sufficient size), and registered agents. Likewise, attorneys and individuals tasked with managing the bankruptcy case for the transferee may be identified on the docket or in filed proofs of claim. The demand should be sent to one or more of these individuals. The more the better.

Like Best Practices Tip # 1, this can be a time-consuming process. But it results in better response rates and reduced costs associated with filing complaints on claims that can be easily resolved without litigation (whether that be settlement or abandonment due to a complete defense). For example, in a case we are currently working on, our first set of demands resulted in a response rate of 85%. This has allowed us to resolve claims well ahead of the statute of limitations and reduced the ultimate cost to the estate pursuing these claims, both in reduced filing costs and reduced attorneys' fees.

In addition, doing this work upfront will make filing complaints easier. The complaint (if you send a draft as part of your demand, which we always recommend) is already drafted (though it may need some tweaks depending on what transpired after the demand was sent) and the registered agent already identified. This benefit cannot not be understated, especially in larger cases.

Negotiating Strategies

Prefernece negotiations can involve two wildy different counterparties. First, the outraged business executive/owner who can't possibly understand the public policy behind preferences and who is driven by emotion and anger. Second, the defendant who has been through the process before and comes without emotional baggage.

Setting aside the emotion for just a moment, in both instances, negotiations need to be thoughtful with offers and counteroffers being proportional to the strength of available defenses. This point sounds obvious, but in our experience, it's not often the case. Far too often estate professionals engage in a "one size fits all" negotiating strategy. The worst form of this strategy is the "preference scorecard" where a paralegal or other estate professional is instructed to contact preference defendants with the goal of recovering a specific percentage based upon some arbitrary analysis like the type of creditor they are (trade, landlord, service provider, etc.). "Preference bingo" as we call this strategy is a surefire way to squander good cases and recoveries in the name of efficiency. A similar (but equally as bad) strategy we have encountered involves an estate representative sending out initial demand letters offering a "quick settlement" for 50%. In both instances, all analysis and negotiating nuance has been intentionally abandoned. In every aspect of law, we lawyers are paid for the exercise of our judgment, preferences should be no different.

In our practice, every Wednesday afternoon a group of senior lawyers (usually 3 or more) meet to develop custom negotiating strategies and tactics to deploy in that week's active negotiations. Every case is different just as every defendant has their own needs, desires, and pain points. There is no "one size fits all" strategy in any aspect of the law and just because preferences are repetitive and done at scale doesn't make them any different. To this end, we develop individualized case strategies to maximize recovery.

Let's return to the emotional and angry executive who can't imagine how "Congress could be so stupid as to permit preferences". Academic literature is full of strategies to manage emotion by the opposing party, but we have found three specific strategies to be the most effective. First, stay calm and be patient. Maintaining your composure and simply listening to these individuals throughout the negotiation will maximize your recovery. Emotional individuals almost always become more reasonable once they have had a chance to express their feelings. Second, focus on the collective fairness to all creditors generated by preference recoveries. While defendants care most about their own pockets, most (but not all) will, given enough time, come to understand the logic of evening out recoveries among similarly situated creditors. And finally, push toward a mediation. When emotion remains a barrier, a neutral and trained mediator will help defuse the emotion and turn the negotiations back toward economic considerations that foster settlement.

Be Principled – Your Recoveries Will Be Higher

We have prosecuted countless preference actions and, like most other aspects of life, the Pareto Principle dominates chapter 5 recoveries. At Bankruptcy Recovery Group, we find that 15% of our cases account for 85% of the value of the dollars we recover for our clients. Big preference cases produce big recoveries, shakedown cases produce relatively little recovery and much of that limited recovery is eaten up by fees and costs. This observation leads to two inviolable rules in avoidance litigation.

First, don't settle good cases cheap. Because such a large percentage of your overall recovery in an estate will be dictated by a few large cases, you can't afford to settle them on the cheap. Unfortunately, our experience is that trustees and skilled practitioners regularly get this principle completely backwards. Too often, estate representatives settle large cases for a lower recovery percentage (albeit still a large dollar amount) than the smaller cases. The appeal of settling for a meaningful recovery can be strong, but large cases need to be maximized as they will ultimately drive the overall recovery. And while bigger cases take more resources and time than smaller cases, that relationship isn't linear. Usually, a case that recovers 10x or 25x the "average case" is only 2x or 5x more work.

To this end, you need to be prepared to take good cases to trial. While settlement is always the preferred outcome, it's not the preferred outcome at any cost. In most cases, we start settlement negotiations at 90 cents on the dollar of projected liability. However, discounts off that 90% of projected liability are not automatic, and candidly the bigger the case, the less inclined we are to recommend material reductions in settlement positions.

Second, don't prosecute shake down cases. Prosecuting weak cases rarely (if ever) moves the needle for your estate. In addition to being ethically dubious, prosecuting shakedown cases rarely recovers more than a few nuisance dollars. But those dollars you do collect are more than offset by the loss of your long-term credibility. And in preference recovery, your credibility is king. For nearly all of you, you will be prosecuting preference claims for years if not decades to come. You will encounter the same lawyers and defendants time and time again. Having a reputation for maximizing benefit recovery in good cases will pay dividends over years and many estates. And one more thing to keep in mind about weak cases, they divert your resources and attention from the cases that will be the primary driver of the estate's recoveries.

At Bankruptcy Recovery Group, we make it known we don't prosecute shakedown cases, but we don't settle good cases cheap.

15% Of Your Cases Will Produce 85% of Your Recoveries

"Don't prosecute shakedown cases, and don't settle good cases on the cheap"

Some Thoughts on Filing Complaints

At some point it will become necessary to file complaints. Having a plan is essential. But there is one thing that we have noticed helps everything run a bit smoother - filing complaints in batches. Filing complaints in batches spreads the case out over time. One of the benefits of this approach is that it helps manage opposing counsel. Similarly, filing seventy complaints over the course of a few days will inevitably result in a flood of responses that, unless you have sufficient staff, is difficult to manage. If you employ the procedures motion we discuss in the next section, filing complaints in batches spreads mediations out over time, which is helpful from a scheduling standpoint. But perhaps most importantly, there are certain creditors that are simply not going to respond to the demand. There is no reason to wait until the statute of limitaitons is about to expire file complaints against unresponsive transfreees. Make sure you have time to deal with these creditors that want to negotiate right after a case is filed.

Filing complaints in three batches tends to make sense. The first batch consists of transferees that simply did not respond to the demand letters. The second batch consists of those transferees who did respond but where settlement negotiations have hit a sticking point or where the transferee has stopped engaging in settlement discussions. The third batch consists of those matters where good faith negotiations continued but where a resolution was not reached. This final batch is often filed shortly before the statute of limitations runs so as to provide as much time as possible to reach a consensual resolution without incurring the costs associated with filing suit.

File Procedures Motions to Maximize Efficiency and Speed

Efficiently handling avoidance litigation does not end once demands are sent. It is crucial to continue managing the estate's claims efficiently once the statute of limitations has run and all of your adversary proceedings are commenced.

One crucial step in efficiently managing the estate's claims is seeking entry of a procedures order. In a case in which there are dozens or even hundreds of avoidance actions that must be litigated, having streamlined procedures is critical. Not only do they provide structure to an otherwise unwieldy process, but they facilitate an expedited resolution of the majority of the avoidance actions, leaving only a small subset to actually litigate.

Here are a few provisions you should be sure to include in the procedures motion:

- Require all defendants to complete a mediation within a set timeframe (unless they expressly opt out).
- Provide a list of pre-approved mediators that the defendant may select from, ensuring that if a mediator is not selected, the plaintiff will select the mediator.
- Set the requirements for what information must be exchanged in the mediation briefs and on what timeline.
- Create a rubric for the length of a mediation and the payment to the mediator based on the amount at issue (or perhaps the amount at issue after deducting agreed upon defenses).
- Waive the requirement to conduct a pre-trial conference and prepare a discovery plan until after the mediation process is completed.
- Stay all formal discovery until the mediation process is completed (noting that informal discovery as part of the settlement process is encouraged).
- Establish discovery and pre-trial deadlines in the event that an adversary does not settle at mediation.
- Schedule omnibus hearing dates for all avoidance action adversaries to ensure that all adversary matters are heard on set dates rather than one-off hearing dates for every motion or discovery issues raised by a defendant.

Of particular importance is the mediation process. Our experience tells us that requiring mediation before the commencement of formal discovery encourages resolution of claims in an efficient and timely manner. The mediation process achieves this end by encouraging the informal exchange of information (which not only allows you to evaluate the strength of the claim but requires the transferee to take a critical look at its defenses) and by preventing the other party from dragging out the process through discovery. The net result is that "settleable" cases are resolved, leaving only those with truly complicated legal or factual issues for litigation. Another important facet of the mediation process is that it prevents transferees from incurring unnecessary legal cost prior to settlement negotiations. As a result, there are more funds available for settlement.

Click Here to download a complete court-approved procedures motion, including the exhibits and order.

Fee Structures and Specialization Return More to the Estate

Preference claims can be expensive to litigate. And because legal fees are generally not recoverable, they can consume the recovery, leaving little for the estate. This is why it is important to be thoughtful about fee structures and specialization.

Contingency fee structures are exceptionally well-suited for avoidance actions and improve the estate's recovery. There are three key reasons for this. First, contingency fees are less risky for the estate. With legal fees tied directly to recovery, you can ensure that the estate only pays legal fees when the estate is paid. Second, contingency counsel's interests are aligned with the estate's, ensuring that the maximum recovery is achieved as expeditiously as possible. The reality is attorneys working on an hourly basis are not similarly motivated. Third, you have more leverage. While the defendant must pay its lawyers on an hourly basis irrespective of the outcome, you do not. Thus, the often used defense tactic of attrition through delay and increased costs is eliminated from the defendant's arsenal. A contingency fee structure becomes an arrow in your quiver.

Counsel with specialization in avoidance litigation also improves the estate's returns. Counsel with a deep understanding of avoidance litigation provides an incredible advantage. Often in litigating preferences, there is imperfect information or an asymmetry of information. Firms with significant experience litigating preferences will, inevitably, be better able to navigate these imperfections and asymmetries by drawing on experience to identify potential issues and pitfalls. In addition, they are more nimble. In short, instead of having to research each defense raised, they understand the issues and can immediately respond and advance the case. A specialized firm can identify issues before they are raised, expeditiously evaluate the merit of the claim, and resolve it more quickly. And because avoidance actions do not age well, quicker resolution equals greater recovery.

At Bankruptcy Recovery Group, we not only have this specialized knowledge, but we have built technology to put this knowledge to use, enabling us to produce greater recovery more quickly.

Why We Built Bankruptcy Recovery Group

30 Cents on the Dollar is NOT an Acceptable Recovery

Bankruptcy Recovery Group was founded by attorneys who have spent their entire careers practicing bankruptcy law, including representing Chapter 7 Trustees, Chapter 11 Debtors and Liquidating Trusts. Our experience is that preferences have been so underserved that fiduciaries have come to think of them as having little value except in the largest of cases. Too often, preferences are an afterthought. And far too often preferences are settled for far less than they are worth. In a preference case, 30 cents on the dollar is not an acceptable recovery for a solid case.

Bankruptcy Recovery Group was founded on that idea. Maximize recoveries for estates and their creditors by using technology, scale, experience, and human capital.

Let us make you a proposal. Contact us at info@brg.legal or 702-483-6126

About the author

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Garrett received his law degree from the Emory University School of Law, with honors. Over the course of his career, Garrett has represented both debtors and creditors in a wide range of bankruptcy and insolvency related matters. Garrett has substantial experience prosecuting and defending preference claims, fraudulent transfers claims and other complex collection matters. Before practicing law, Garrett worked in the accounting field, having received his finance degree from Arizona State University. Garrett is admitted to practice law in Illinois.