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Bon Ton--Will Avoidable Preference Exposure Make A Creditor's Bad Situation Worse?

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Bon Ton Inc., which operates department stores around the country under the Boston Store, Carson's, Bon Ton, Bergner's, Elder-Beerman and Herberger's flags, has been a retail mainstay in Wisconsin and the Midwest. On February 4, 2018, Bon Ton filed a Chapter 11 bankruptcy in a failed attempt to locate a going concern buyer. In early April 2018, its assets were purchased in a bankruptcy auction by a consortium of liquidators, which almost immediately commenced going out of business sales that are expected to be completed by August 31.

Bon Ton's creditors are trying to determine what their rights will be and, more importantly, what they may recover from the bankruptcy process. Bon Ton was burdened with a huge of amount of debt. The first lien and the second lien creditors held pre-petition claims totaling approximately $850 million. Bon Ton borrowed $725 million in post-petition financing to operate during the Chapter 11 process, and the total pre-petition priority and unsecured claims totaled almost $118 million. The unsecured claims will likely be increased significantly by the claims of landlords whose leases will be rejected following the going out of business sales. Consequently, the prospects of unsecured creditors receiving much, if anything, on account of their pre-petition claims, are slim indeed.

In addition to having to write off as uncollectable pre-petition amounts due from Bon Ton, many unsecured creditors may suffer an even more disappointing set back -- having to give back payments which they have already received. In virtually every Chapter 11 case, either the debtor, or a liquidating trust created by the debtor, will pursue avoidance actions to recover certain amounts paid by the debtor prior to the bankruptcy. Chief among these are avoidable preferences recoverable under section 547 of the United States Bankruptcy Code. The theory behind recovering these payments, which were entirely legal and appropriate when made, is to ensure that all creditors of the debtor are treated equally, rather than favoring some creditors who were paid at the expense of others who were not.

Under section 547, pre-petition payments by the debtor are avoidable if made (1) to or for the benefit of a creditor; (2) on account of an antecedent debt, (3) within the 90 days preceding the bankruptcy petition (or within one year if the payment is to an insider); (4) while the debtor was insolvent; and (5) which result in the creditor receiving more than it would have received in a Chapter 7 liquidation had the payment had not been made. Given Bon Ton's financial circumstances, each of these elements will likely be met.

Although meeting the above definition of an avoidable preference, certain payments may be exempt from avoidance if they fit within the provisions of section 547(c), which sets forth nine defenses to avoidance. For unsecured creditors, the two most common defenses are the ordinary course of business defense, described in section 547(c)(2), and the new value defense, described in section 547(c)(4).

The ordinary course of business defense exempts from avoidance payments of debts incurred in the ordinary course of business of the debtor and the creditor, which payments are made in the ordinary course of business or financial affairs of the debtor and the creditor, and which are made according to ordinary business terms. While an alteration to the historical terms of payment (such as requiring a cashier's or certified check instead of a regular company check) will make the defense inapplicable, this defense most often turns on comparing the historical payment history between the debtor and the creditor, and, specifically, how the payments received during the preference period compare to the payments received during the entire historical relationship of the debtor and creditor.

In a recent decision, *The Unsecured Creditors Committee of Sparrer Sausage Co. v. Jason's Food's, Inc.,* 826 F.3d 388 (7th Cir. 2016), the Seventh Circuit Court of Appeals discussed the ordinary course of business defense and noted that there are two principal tests used by courts when analyzing the payment history to determine an ordinary course range. Some courts use the total-range method, which uses the minimum and maximum invoice ages during the historical period to establish the range. While this method provides a complete picture of the parties' relationship, it has been criticized because it has a tendency to skew the range by payments that are outliers. As an alternative, other courts use the average-lateness method, which uses the average invoice payment date during the pre-petition historical period to determine which payments made during the preference period were outside the ordinary course of business, and therefore avoidable. This method may provide a more accurate depiction of ordinary course because it compensates for outlier payments. The total payments are grouped into buckets to determine the percentage of payments which are made later than the historical average time of payment. For example, if 85% of the payments made during the historical relationship of the debtor are made within twenty days from the due date, payments made during the preference period within twenty days of the due date would be deemed to be in the ordinary course of business, and payments made more than twenty days of the due date would not and would be recoverable

The other defense which is commonly available to unsecured creditors is the new value defense under Code section 547(c)(4). Under this section, the creditor receives a dollar for dollar credit against payments which are otherwise avoidable for goods shipped to the debtor after such payments have been made. The theory behind this defense is to encourage creditors to continue to ship goods to a struggling debtor. Note that unlike the law under the prior Bankruptcy Act, shipments which are delivered before a preferential payment is made do not qualify for the defense. Additionally, there is significant litigation over whether shipments made and subsequently paid for by the debtor, because of a critical vendor motions, for example, are eligible for the defense.

While an unsecured creditor who received no payments during the preference period may benefit by the debtor's or liquidating trustee's aggressive pursuit of preferences, creditors who have been paid within the period suffer the cost of defending against the preference claims and the risk of having to repay amounts received if their defenses are not allowed by the court. Moreover, preference recoveries go first to pay any unpaid administrative expenses, including the cost of the preference litigation, further reducing the net benefit to all unsecured creditors.

Bon Ton creditors would be well advised to discuss with their legal advisors all payments which they received during the preference period, identifying which defenses may apply and gathering records to support the defenses. Doing this now will prevent a creditor who may not receive any distribution on its pre-petition claim from subsequently receiving another unexpected and unwelcomed surprise.