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Preference Litigation Pursuant to Chapter 128 of the Wisconsin Statutes vs. Preference Litigation Pursuant to the United States Bankruptcy Code

Many creditors have had the unfortunate experience of receiving a demand letter or adversary complaint alleging that they received avoidable transfers—commonly known as "preferential payments" or "preferences"—during the 90 days preceding a customer's federal bankruptcy filing. Such claims arise under section 547 of the Bankruptcy Code, and can result in a creditor having to return certain payments made during the 90-day preference period.

What some creditors of Wisconsin companies may not know, however, is that the Bankruptcy Code is not the sole source of preference litigation in Wisconsin. Chapter 128 of the Wisconsin Statutes provides for the ability to liquidate a company in a state-court receivership action via a process that is vaguely similar to a Chapter 7 liquidation under the Bankruptcy Code. Wisconsin Statute § 128.07 allows the receiver in a Chapter 128 receivership to recover preferential transfers made to creditors within the four months preceding the receivership.

The theory behind preference litigation under Chapter 128 is the same as under the Bankruptcy Code: To place creditors who received payments just prior to the receivership in the same position as creditors who did not receive such payments, thereby forcing them to share pro rata with other creditors in the assets of the debtor's estate. Though similar in concept, preference litigation under Chapter 128 varies from preference litigation under the Bankruptcy Code in some important ways. A summary of some of the more significant differences is provided below.

Different Preference Elements

Preferences under the Bankruptcy Code and Chapter 128 share many common elements: (a) there must have been a transfer of the debtor's property; (b) the transfer must have been made to a creditor; (c) the transfer must have been made while the debtor was insolvent; (d) the transfer must have enabled the creditor to receive more than it would have received in bankruptcy or receivership; and (e) the transfer must have been made on account of antecedent debt (although this element is implied rather than explicit in Chapter 128).

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There are two primary elements of Chapter 128 preferences that differ from preferences under the Bankruptcy Code. The first is that a Chapter 128 receiver may seek to recover preferential transfers made by the debtor within the four months (roughly 120 days) before the receivership. Wis. Stat. § 128.07(2). This is approximately one month longer than the 90-day preference period provided by section 547 of the Bankruptcy Code. 11 U.S.C. § 547(b)(4)(A). The Bankruptcy Code also provides for a one-year preference period for "insiders" of the debtor. 11 U.S.C. § 547(b)(4)(B). Chapter 128 does not treat insiders differently than other creditors.

The second major difference is that Chapter 128 provides that, in order for a transfer to be preferential, the recipient must have had "reasonable cause to believe that the enforcement of the. . . transfer would effect a preference." Wis. Stat. § 128.07(2). In practice, this generally means that the creditor must have had knowledge or reasonable cause to believe that the debtor was insolvent at the time of the transfer, because without such knowledge the creditor would have no reason to believe that a transfer would result in a preference.

Borrowing from bankruptcy case law decided under the Bankruptcy Act of 1898, on which Chapter 128 is largely based, it is clear that the receiver does not need to show that a creditor had actual knowledge of the debtor's insolvency in order to satisfy this element. See In re Eggert, 102 F. 735, 741 (7th Cir. 1900). Facts known to a creditor that "ought to have put a prudent man upon inquiry" into the debtor's solvency may be enough to establish the requisite "reasonable cause to believe." *Id*. However, late payments or general suspicion about a debtor's financial condition alone is not enough to establish this element. *See e.g., Grant v. Nat'l Bank*, 97 U.S. 80, 82-83 (1877); *In re Salmon*, 249 F. 300, 303 (2d Cir. 1917).

Different Preference Defenses

Two of the most common defenses to an alleged preference under section 547 of the Bankruptcy Code are the "new value" defense and the "ordinary course of business" defense.[1] 11 U.S.C. 547(c)(2) and (4).

The "ordinary course of business" defense—which essentially provides that payments received in the ordinary course of business between the debtor and creditor or made according to applicable industry standards are not subject to avoidance by the trustee—is not available in Chapter 128 preference actions. However, a pattern of payment on ordinary terms during the preference period would weigh against the receiver's ability to prove that the creditor had

reasonable cause to believe that the debtor was insolvent.

The "new value" defense—which provides that to the extent a creditor gives "new value" (usually in the form of additional goods or services) to the debtor after receiving preferential payments, the creditor is entitled to reduce its preference exposure by offsetting the new value against the preferential payments—is not explicitly available in Chapter 128 preference actions. However, again borrowing from case law under the Bankruptcy Act of 1898, it appears that creditors are indeed entitled to make use of the new value defense. *See Kimball v. E.A. Rosenham Co.*, 114 F. 85, 87-89 (8th Cir. 1902). In fact, Bankruptcy Act case law supports a "net result" application of new value in some instances, whereby the amount of the preference may be reduced to the net result of the total sales minus the total payments received during the four-month preference period. *See Walker v. Wilkinson*, 296 F. 850, 853 (5th Cir. 1924); *In re Watkinson*, 142 F. 782, 784 (D.C. Pa. 1906). At a minimum, a creditor's willingness to continue providing goods or services to a debtor on credit would tend to establish that the creditor did not know or have reasonable cause to believe that the debtor was insolvent.

Conclusion

A creditor's strategy in responding to an allegation that it received an avoidable preference will differ substantially depending on whether the preference allegation arises under Chapter 128 of the Wisconsin Statutes or the Bankruptcy Code. What may be a strong response to a preference allegation under the Bankruptcy Code may be nearly irrelevant under Chapter 128 and vice versa.

Please contact your Reinhart attorney or any attorney in Reinhart's Bankruptcy and Creditors' Rights Service Area if you have any questions concerning preferences under Chapter 128 or the Bankruptcy Code.

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[1] There are a number of less common preference defenses available under both the Bankruptcy Code and
Chapter 128 that are not discussed here.