

# Bankruptcy and the Preferential Payment Rule

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December 2020

Agricultural Law and Taxation Blog, by Roger McEowen: <https://lawprofessors.typepad.com/agriculturallaw/>  
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## Overview

Economic times continue to be difficult in much of agriculture. 2020 has been a difficult year economically for many agricultural producers as well as commodity processors and other agribusinesses. An issue that frequently arises in bankruptcies of purchasers of agricultural products like grain, livestock, fruit or milk is known as the “preferential payment rule.” It can be a surprise not only to farmers in financial distress, but also to creditors who receive payment for agricultural goods sold shortly before the buyer files bankruptcy. It’s an issue that can arise in the normal course of doing business before bankruptcy is filed when nothing “unusual” appears to be happening.

A decade ago, the preferential payment rule arose in the context of the VeraSun bankruptcy. Now, it’s back in relation to bankruptcy filing of Dean Foods, the largest dairy subsidiary company in the United States. Dean Foods and its forty-three affiliates filed Chapter 11 bankruptcy on November 12, 2019 in the United States Bankruptcy Court for the Southern District of Texas, which is being jointly administered under case no. 19-36313. Earlier this week, Dean Foods and its affiliates filed a joint Chapter 11 plan of liquidation.

Farmers that sold milk to Dean Farms shortly before the bankruptcy filing are now receiving letters demanding repayment of the amount paid for those milks sales. Do these demand letters need to be responded to? Are they legitimate? The answer rests in the bankruptcy code’s preferential transfer rule.

For today’s article, I have asked for insight from one of the premier farm bankruptcy attorneys in the country. Joe Peiffer of Ag and Legal Business Legal Strategies of Cedar Rapids, Iowa helped author today’s article. His insights on how farmers should respond to the demand letters being sent to farmers on behalf of Dean Foods are particularly insightful.

The preferential payment rule, a unique bankruptcy provision – it’s the topic of today’s post.

## In General

[11 U.S.C. §547](#) provides in general that when a debtor makes a payment to a creditor and the debtor files bankruptcy within 90 days of making the payment, the bankruptcy trustee can “avoid” the payment by making the creditor pay the amount received to the bankruptcy estate where it will be distributed to the general creditors of the debtor. *11 U.S.C. §547(b)(4)(A)*. The timeframe expands from 90 days to one year if the creditor is an “insider.” *11 U.S.C. §547(b)(4)(B)*. The rule can come as a shock to a creditor that has received payment, paid their own creditors from the funds received from the debtor, and now has no funds to pay the bankruptcy estate to satisfy the bankruptcy trustee’s avoidance claim.

However, there is a jurisdictional limit. When the bankruptcy trustee seeks to recover a money judgment of less than \$25,000, any associated legal action must be brought in the defendant’s (dairy farmer’s) home jurisdiction. *28 U.S.C. § 1409(b)*. Thus, a New York dairy farmer could only be sued in New York and a Wisconsin dairy farmer could only be sued in Wisconsin, etc., etc. Out of 1,881 dairy farmers identified as potentially having been paid by Dean Foods within 90 days of the bankruptcy filing, 708 have total payments under the \$25,000 threshold.



There is also an administrative priority provision that can possibly apply. Under this provision, claims for deliveries that are made within in 20 days of the bankruptcy filing are elevated to the priority of an administrative expense claim. *11 U.S.C. §503(b)(9)*. In the Dean Foods bankruptcy, the 20-day timeframe would apply to deliveries made on or after October 23, 2019 until the petition date of November 12, 2019. The provision only covers deliveries. It does not cover payments. Of the 13,510 potentially preferential payments listed in the Dean Foods Statement of Financial Affairs, 1,590 could potentially cover deliveries made in that 20-day period.

## Exceptions

The preferential payment rule does come with some exceptions. The exceptions basically comport with usual business operations. In other words, if the transaction between the debtor and the creditor occurred in the normal course of the parties doing business with each other, then the trustee's "avoidance" claim will likely fail.

**Exchange for new value.** The bankruptcy trustee cannot avoid a transfer to the extent the transfer was intended by the debtor and the creditor (to or for whose benefit such transfer was made) to be a contemporaneous exchange for new value given to the debtor, and occurred in a substantially contemporaneous exchange. *11 U.S.C. §547(c)(1)(A-B)*. A contemporaneous exchange for new value is not preferential because it encourages the creditor to deal with troubled debtors and because other creditors are not adversely affected if the debtor's estate receives new value. See, e.g., *In re Jones Truck Lines, 130 F.3d 323 (8th Cir. 1997)*. "New value" as used in *Section 547(c)* means "money or money's worth in goods, services, or new credit." *11 U.S.C. § 547(a)(2)*. An exchange for new value is presumed substantially contemporaneous if the transfer of estate property is made within seven days of the transfer of the new value. See, e.g., *In re Mason, 189 B.R. 932 (Bankr. N.D. Iowa 1995)*.

**Ordinary course of business.** The bankruptcy trustee also cannot avoid a transfer to the extent that the transfer was in payment of a debt that the debtor incurred in the ordinary course of the debtor's business (or financial affairs) with the creditor, and the transfer was made in the ordinary course of business or financial affairs of the debtor and the creditor; or was made according to ordinary business terms. *11 U.S.C. §547(c)(2)(A)-(B)*. If the transaction at is the first between the parties, "the transaction must be typical compared to both parties' past dealings with similarly-situated parties. *In re Pickens, No. 06-01120, 2008 Bankr. LEXIS 6 (Bankr. N.D. Iowa Jan. 3, 2008)*.

So how can a farmer demonstrate an ordinary course of business? Basically, it is shown by demonstrating that the transfer to the debtor was consistent with a pattern of previous transfers between the parties. Business transactions between the parties that are within the norm of industry practice are essential to establishing that the transactions occurred in the ordinary course of business. Also, a payment that is made in the "ordinary course of business" between the debtor and the creditor will involve invoices that are paid in the time period required on the invoice, or payment made in accordance with industry custom or past dealings.

**Settlement Payment Via Forward Contract.** A trustee also cannot avoid a transfer that is a settlement payment made by a forward contract merchant in connection with a commodity contract or forward contract entered before the bankruptcy petition is filed. *11 U.S.C. §546(e)*.

**Security interest.** A trustee also cannot avoid a transfer that creates a security interest in property that the debtor acquires that secures new value given in accordance with a security agreement that contains a description of the property as collateral and is perfected on or before 30 days after the debtor receives possession of the property.

## Recent Case



A recent court decision from Arkansas illustrates how the preferential payment rule can apply in an agricultural setting. In [\*Rice v. Prairie Gold Farms, No. 2:17CV126 JLH, 2018 U.S. Dist. LEXIS 51678 \(E.D. Ark. Mar. 28, 2018\)\*](#), the debtor was a partnership engaged in wheat farming activities. The debtor entered into two contracts for the sale of wheat with a grain broker. The contracts called for a total of 10,000 bushels of wheat to be delivered to the broker anytime between June 1, 2014 and July 31, 2014. In return, the debtor was to be paid \$6.78/bushel for 5,000 bushels and \$7.09/bushel for the other 5,000 bushels for a total price of \$69,350. The debtor delivered the wheat in fulfillment of the contracts on July 21, 2014 and August 4, 2014 and received \$71,957.10 later in August, in return for a total delivery of 10,813.07 bushels.

The grain broker debtor subsequently filed Chapter 11 bankruptcy on October 23, 2014 (which was later converted to Chapter 7). The Chapter 7 trustee sought to avoid the payment for the farmer's wheat crop by the grain broker as a preferential transfer under [11 U.S.C. §547\(b\)](#) and return the money paid to the farmer for his wheat crop to the bankruptcy estate for distribution to creditors. The trial court disagreed with the trustee, noting that [11 U.S.C. §547\(c\)\(1\)](#) disallowed avoidance of a transfer if it is made in a contemporaneous exchange for new value that the debtor received. The trustee claimed that the transfer of wheat was not contemporaneous because the contract was entered into in May and the wheat was not delivered and payment made until over two months later.

The trial court determined that the transfer was for new value and payment occurred in a substantially contemporaneous manner corresponding to the delivery of the wheat. Thus, the exception of [11 U.S.C. §547\(c\)\(1\)](#) applied. The court also noted that the wheat sale contracts were entered into in the ordinary course of the debtor's business and, thus, also met the exception of [11 U.S.C. §547\(c\)\(2\)](#). The debtor and the grain broker had a business history of similar transactions, and the court noted that the trustee failed to establish that the wheat contracts were inconsistent with the parties' history of business dealings.

In the Arkansas case, the court noted that the parties had prior dealings that they conducted in the same manner and that nothing was out of the ordinary. There wasn't any attempt to defraud creditors or shield assets from the reach of creditors. That's really the point behind the preferential transfer rule. For those that continue conducting business as usual, the rule won't likely come into play.

## Response to Preference Demands

**Information gathering.** For a farmer or other creditor that receives a demand letter from attorneys representing Dean Foods or any other debtor in bankruptcy, it is important to immediately assemble documentation to provide to competent bankruptcy counsel to respond to the demand for return of the preferential transfer.

Dairy farmers that were selling milk to Dean Foods directly or to a subsidiary that have received preference demand letters should assemble the following:

- Payment evidence, such as milk check stubs or electronic funds transfer receipts. This will show when the milk was delivered to the dairy, as well as when the dairy made payment for the milk.
- Contracts for delivery of milk should be provided to counsel as it will assist the farmer in demonstrating that the payment by the dairy qualifies to protect the farmer from the preference demand. Since dairies generally make payment for the milk twice a month like clockwork, the preference demands can be defeated using the ordinary course of business defense outlined above.
- Any other documentation that helps establish a normal, standard industry practice of business dealings with Dean Foods.



**Positing a defense.** Failure to respond to the preference demand letters will generally mean that the dairy farmer will be sued by the liquidation trust in the United States Bankruptcy Court for the Southern District of Texas in Houston, TX. Such a lawsuit will seek to recover the payments made within 90 days of the bankruptcy filing. In the Dean Foods bankruptcy this would mean payments that cleared the dairy's bank after August 14, 2019.

In many instances, demands for the return of payments made to farmers are made without any consideration by the demanding party having considered whether the defenses to a preference action, such as ordinary course of business, is applicable. The demands are frankly extortion demands seeking some money without any actual right to the money. The parties demanding return of the *preferences* are banking on the willingness of the farmer to purchase a release rather than consider defenses and respond to the preference demand so they can avoid the cost of defense of the preference action in Houston, TX. In the VeraSun bankruptcy case, a group of lawyers formed the VeraSun Preference Defense Group to analyze and propose responsive letters to the parties demanding the return of the allegedly preferential payments. Most of the thousands of demands were withdrawn when the indefensible demands were exposed. A similar effort should be mounted in the Dean Foods bankruptcy.

### Conclusion

Understanding the preferential payment rule is important, especially in the context of agricultural bankruptcies. The matter can get complicated in agricultural settings with the use of deferred payment contracts, forward grain contracts and the various types of unique business relationships that farmers enter into with the purchasers of their commodities. Competent legal counsel well-trained in the intricacies of agricultural law is a must.

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