

Avoiding Liability For Bankruptcy Preference Claims

by Bradley R. Kruse

We Just Received A Preference Claim, Now What?



Receiving a demand letter or lawsuit for the return of preferential payments to a bankrupt debtor is typically a frustrating situation for creditors. To creditors that have not had much previous experience dealing with bankruptcy preferences, being hit with a preference claim can seem especially confusing and unfair. The conversation with the attorney usually begins something like this, with the creditor in an agitated tone:

“The debtor owed us \$150,000 at the time they filed bankruptcy almost two years ago and the information we have so far is that we are only going to receive pennies on the dollar from the debtor. Now, after all this time, someone representing the bankruptcy trustee says we have to give back the few payments we did receive from the debtor. How can this be?! These payments total almost \$100,000 on top of what we are owed!”

As frustrating as this situation may seem at first, if creditors understand preferences, as well as their rights and defenses, creditors can often greatly reduce their preference liability if not eliminate it entirely.

Bankruptcy Preferences Explained

The Bankruptcy Code contains provisions allowing a bankruptcy trustee (which includes a debtor-in-possession in a Chapter 11 case) to recover any payments the debtor made within 90 days before filing for bankruptcy to a creditor on account of antecedent debt, provided the debtor was insolvent and such payments enabled the creditor to receive more than the creditor would have received if the case were a Chapter 7 liquidation.

The purpose of these provisions is to prevent a debtor from paying some creditors and not others during the time period leading up to the debtor's bankruptcy. The theory is that debtors experience a period of financial difficulty prior to filing for bankruptcy, and that especially in the 90-day period prior to the bankruptcy, debtors, who already have limited funds, are often tempted or pressured to pay certain creditors with their limited funds. The result is that some creditors are “preferred” over others. The goal of the Bankruptcy Code is to prevent or limit such preferential treatment by allowing the trustee to recover any preferential payments and subsequently distribute the proceeds to unsecured creditors on an equal or “pro rata” basis.

In order to promote these goals of equal distribution to creditors and to allow the trustee adequate time to investigate and evaluate potential preference claims, the Bankruptcy Code allows the trustee to file a preference action up to two years following the filing of the debtor's bankruptcy. Most trustees usually send creditors a demand letter notifying the creditors of

1 Creditors will typically want to calculate this based on number of days from invoice or delivery rather than on number of days late.

the specific payments at issue and requesting repayment by a specific date. However, if the two-year time limit for filing suit is fast approaching, some trustees will simply file suit first without sending a demand letter.

Defenses to Preference Claims

The explanation of the policy goals behind recovering preference payments may be of hollow comfort to a creditor facing a claim from a bankruptcy trustee that a six-figure amount be returned to the debtor's bankruptcy estate. However, all is not lost. The Bankruptcy Code provides a number of defenses to preference actions. Creditors can often use one or more of these defenses to negate a preference claim in its entirety or to negotiate a settlement for a much lower dollar amount. Three of the more common defenses are: 1) Contemporaneous Exchange; 2) New Value; and 3) Ordinary Course. It is important for creditors faced with a preference demand or suit to seek guidance from legal counsel in order to maximize the effectiveness of these defenses.

Pursuant to the Contemporaneous Exchange Defense, a creditor may avoid liability for any asserted preferential payment if such payment was intended by the debtor and the creditor to be a contemporaneous exchange for new goods or services and was, in fact, a substantially contemporaneous exchange. An example of this would be a COD payment.

Under the New Value Defense, a creditor may avoid preference liability to the extent that the creditor gave new value to the debtor after the transfer in question, such as by furnishing additional products or services on credit. Specifically, subject to some limitations set forth in the Bankruptcy Code, creditors can effectively offset additional credit that was provided to the debtor after any of the preference payments in question. Some districts require that the amount of new value remain unpaid, while other districts do not impose such a requirement.

The Ordinary Course Defense allows creditors to avoid liability for any preferential payments that were made in the ordinary course of business dealings between the creditor and the debtor or that were made according to ordinary business terms. An example of the latter is payments paid in accordance with the terms of the invoice. For example, if the preference payment in question was made within 25 days of the invoice and the term of the invoice was net 30 days, the creditor may assert that payments were made according to ordinary business terms.

The Ordinary Course Defense is also based on the concept that if the debtor and creditor established a regular course of dealing regarding the timing and amount of payments, even if that course of dealing is not in accordance with the terms of the invoices, a valid defense may still be asserted. This is one of a creditor's most powerful defenses, though it is typically very fact intensive. Essentially what the creditor seeks to do is to compose a snapshot of the payment history during the 90-day preference period and compare that with the payment history between the parties prior to the preference period. If the creditor can show that the payment history and course of dealings between the creditor and the debtor were similar for both periods, the creditor has an excellent chance of successfully asserting an Ordinary Course Defense. Some of the more important comparisons to be made between these periods include, range of payments, average time for payments,¹ average amount of each payment, average number of invoices paid by each payment, and the correspondence between the parties. Again, the more similar these comparisons are between the preference period and

the pre-preference period, the stronger the defense will be. If the course of dealing shows more pressure being put on the debtor by the creditor in the 90-day period, the defense is weakened.

Minimizing Preference Risk

Though easier said than done, the best way to avoid preference exposure is to not let a customer get behind in payments very far in the first place. However, once that happens, creditors can try to minimize their exposure to preferences by switching to COD terms if it believes the customer is in financial distress. Creditors will often refuse to ship additional product or perform additional services until the customer pays up on outstanding invoices. Though this may prompt a significant payment from the customer, it most likely will nullify use of the ordinary course defense with respect to such payments should the customer file for bankruptcy within 90 days of the payments. Whether to exert such pressure is a calculation each creditor must make based on the specific circumstances.

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