How Can a Business Escape From the Preference Action Nightmare?

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You've got to be kidding! Please tell me this is not true. XYZ Company still owes my company, ABC Corporation, thousands of dollars for the widgets we delivered before they filed bankruptcy. How can XYZ's trustee, or the same management that stiffed us on the widgets, now expect us to repay all of the money we received in the 90 days before it filed bankruptcy? I didn't do anything wrong. I did business with them all the way up to the bankruptcy filing and just got paid. That can't possibly be the law. It's unfair! How do I get out of this nightmare?

We are all familiar with the high profile bankruptcy cases filed over the last several years. Most attention surrounding bankruptcy cases comes at the early stages of the proceedings when the company enters bankruptcy. Approval of the bankruptcy reorganization plan and the announcement that the company will emerge from bankruptcy also garners attention. What is less visible, yet meaningful to parties that did business with the bankrupt company, is what happens after confirmation of the bankruptcy plan.

The federal Bankruptcy Code empowers a trustee (or debtor-in-possession) to set aside and recover "preferential" transfers. Preferential transfers differ from fraudulent transfers. Preference payments violate the rule against equal distribution. Fraudulent transfers go further by placing assets beyond the reach of creditors. Preference lawsuits are typically commenced at the later stages of the bankruptcy proceeding. In some cases, these lawsuits offer the only hope for general unsecured creditors to receive pennies on the dollar for their claims.

What you should take away from this article is an understanding of the basics elements and defenses of a bankruptcy preference so that you can survive the trustee's demand to pay back money and factors to consider when dealing with a financially troubled customer.

Congress has granted powers to bankruptcy trustees (and debtors-in-possession) to discourage dismemberment of financially distressed debtors and to promote the equality of distribution to similarly situated creditors in bankruptcy cases. Under the Bankruptcy Code, a preference is (1) a transfer, (2) of an interest of the debtor in property, (3) to or for the benefit of a creditor, (4) for or on account of an antecedent, or pre-existing debt, (5) made while the debtor was insolvent, (6) on or within 90 days (one year for "insiders") before bankruptcy, (7) that enables the creditor to receive more than it would receive in a Chapter 7 case if the transfer had not been made.

To survive the preference demand, the creditor should focus on each element and not overlook any arguments. If the trustee fails to meet his burden of proving all seven elements, then the payment cannot be recovered. Even if the trustee proves the seven elements, the creditor may still prevail under one of several exceptions under the Bankruptcy Code.

The primary exceptions, in simple terms, include: (1) there was a substantially contemporaneous exchange for new value, (2) the transfer was a payment on an ordinary course debt, made and accepted in the ordinary course of business and financial affairs of the debtor and the creditor, and made according to ordinary business terms, and (3) the creditor gave new value to the debtor after the payment (but only to the extent of the new value given).

Contemporaneous Exchange Defense. The purpose of the contemporaneous exchange exception is to encourage creditors to continue to deal with financially distressed debtors without fear that they will have to return payments received for goods and services provided. For the creditor, this means extending credit with an expectation and intention between the parties that the debtor will contemporaneously pay for goods and services.

Subsequent New Value Defense. The Bankruptcy Code excepts payments from attack when the creditor gives new value to the debtor on an unsecured basis after receiving the payment. This exception eliminates the unfairness of allowing recovery of all payments in the preference period without giving credit for new value advances.

Ordinary Course of Business Defense. The ordinary course of business defense requires the creditor to show that (1) the underlying debt on which payment was made was incurred in the ordinary course of business or financial affairs, (2) the payment was made in the ordinary course of business or financial affairs of both parties, and (3) the payment was made according to ordinary business terms. This defense has no bright lines and is subject to much interpretation.

Understanding these principles should arm you with knowledge that you can use to survive the demand, and reduce or eliminate the financial risk and hardship associated with the demand. Likewise, this knowledge should help guide you in conducting your future business affairs when dealing with a financially distressed customer. The good news is that most preference cases settle with no trial, with the creditor paying very little or nothing at all in comparison to the initial demand.

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