I've Been Sued for a Preference (and don't feel preferred at all)

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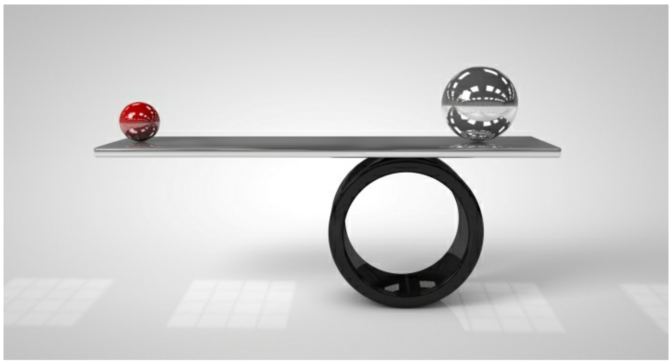

My business received a demand letter from a bankruptcy trustee for a bankrupt customer asking me to return payments I received for goods and services provided to the customer. Do I have to return the payments?

Beware of Preferences

By way of background, a "preference claim" in a bankruptcy case is a legal device created by Congress. The purpose of the preference claim is to ensure that all similarly-situated creditors receive equal treatment for their claims or, said another way, to avoid preferential payments by the bankrupt debtor to certain favored creditors. Congress wanted to make sure that insolvent debtors did not prefer one creditor over another before filing bankruptcy. The preference law is used to bring all transfers or payments made during the "preference period" (which is a specified time period prior to the date the debtor files bankruptcy) back into the bankruptcy estate for distribution to all qualified creditors. For "insiders" of the debtor (owners, officers, or relatives of a debtor), the "preference period" consists of the one-year period immediately preceding the bankruptcy filing. For "non-insiders," the "preference period" consists of the 90-day period immediately before the filing. The end goal of the preference statute is an equal distribution to all creditors, not just a chosen few.

A "preference" is defined as follows: (i) a transfer of an interest of the debtor in property; (ii) to or for the benefit of a creditor; (iii) on account of an antecedent debt; (iv) made while the debtor was insolvent (insolvency is presumed by statute); (v) within 90 days before the bankruptcy filing date (or one year, for insiders); and (vi) that enabled the recipient to receive more by virtue of the payment than the recipient would receive in a straight liquidation bankruptcy case. If the bankruptcy trustee can prove all of these things for any payment or transfer, the trustee can avoid the payments or transfers – except when a defense is available.

While the list is long, there are three primary defenses to a preference claim available to your business:

- A contemporaneous exchange for new value;
- Subsequent new value provided; and,
- Payments made in the ordinary course of business.

The Contemporaneous Exchange Defense

This defense applies where there is a contemporaneous exchange for "new value" provided to the now-bankrupt customer. A payment to you cannot be avoided by the bankruptcy trustee and recovered from you for deposit back into the bankruptcy estate if you can show that the payment was made to you with the intention of being a contemporaneous exchange for new value given by you to the debtor (i.e., goods or services) and was, in fact, a substantially contemporaneous exchange. For example, a contemporaneous exchange would likely be found where your customer pays you the full value of the goods or services at the time those goods or services are provided. Additionally, this defense may apply where the goods or services were sold on very short-term credit – say, on 30-day repayment terms – and were fully paid for by the customer within that 30-day term.

The Subsequent New Value Defense

This defense requires a showing that you provided "new value" (i.e., goods or services) for the benefit of your customer after your receipt of a preferential transfer or payment. For this defense to apply, you must prove two elements: (i) the new value must have been given by you after the preferential payment was received; and (ii) you must not have received any other payment for that new value. To the extent subsequent new value is provided, this defense can be used to offset some or all of your exposure for the preferential payments received.

For example, assume you have received a $100,000 payment within the preference period for goods and services you previously provided to your customer. After your receipt of that payment, you provided that customer, on credit, with additional goods and services that are valued at $75,000. The customer then files for bankruptcy protection without paying for the additional goods and services provided. The subsequent new value defense would apply to reduce your preference exposure to $25,000 – offsetting your exposure by the value of the goods and services you subsequently provided and for which payment was not received.

The Ordinary Course of Business Defense

This defense is intended to protect recurring, customary credit transactions that are incurred and paid in the ordinary course of business. This defense is available if the debt was incurred between you and your customer in the ordinary course of business <u>and</u> you can prove one of the following facts: (i) the payments were made to you in the ordinary course of the business between you and your customer; <u>or</u> (ii) the payments were made according to ordinary business terms.

To defeat a preference based on ordinary business terms, you must show that payments were made according to the ordinary industry standards for your business <u>and</u> your customer's business. Analysis of this "objective" defense requires consideration of the normal industry practices and standards for both your business industry and that of your customer. The payments received must be ordinary from the perspective of each industry. By "industry," I mean firms similar in some general way to your business and your customer's business. The focus will be on standards prevailing in the industry of both businesses. Dun & Bradstreet Registered Reports provide some evidence of payment history and trends. Generally, analysis and testimony from an expert familiar with the respective industries are required.

In addition to the industry-focused "objective test," the determination of whether the payments were made in the ordinary course of business for you and your customer also requires that you prevail with respect to a "subjective test" in which the Bankruptcy Court will compare your and your customer's course of dealing both inside and outside of the applicable preference period. Typically, this will result in an analysis of all transactions between you and your customer made during a sufficiently long period of time prior to bankruptcy. By comparing the frequency and amount of payments made both prior to and during the preference period (both in terms of the average days late and the range of days for payments made), your argument will be that some or all of the payments were made within the ordinary course of business between you and your customer.

For example, assume that over the last few years, your customer has routinely paid for goods and services received from you within 30 days after you send an invoice for payment. Your argument will be that the ordinary course of business defense applies to each payment you received during the preference period that was made within 30 days after the date you sent an invoice to your customer. Payments made much earlier or later than the typical 30 days from the invoice period may be considered outside of the normal course of business between you and your customer and may not be protected from avoidance by this defense. If you had to exert pressure on your customer to get paid within the preference period, that factor would work against your ordinary course of business defense. _

Conclusion

The facts of each case and the timing of payments received by you will control both the existence of a preference and the availability to you of the preference defenses. Due to wide-ranging factual considerations, preference analysis is never an exact science. If your business receives a demand letter from a bankruptcy trustee for the return of preferential payments, you would be well advised to consult with an attorney who is knowledgeable about preference claims and defenses. This attorney can provide a preference analysis and calculate your estimated exposure. By understanding the claims and possible defenses, you may be able to limit your exposure and negotiate a settlement that is fair within the context of bankruptcy laws.

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