

Preferential Payments in Bankruptcy
or
“You Mean I Have to Give the Money Back?”

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In a recent article published in this e-newsletter, we tried to provide a basic understanding of bankruptcy law in very general terms. This article is aimed at a much more specific topic, and one that generates a great deal of inquiries to us – preferential payments to creditors.

The following may soon happen to you, if it hasn't happened already.

After months and months of chasing down a debtor, you receive a check in the mail. Good news all the way around.

Two weeks later, you receive a notice from the Bankruptcy Court that the debtor who finally made a payment to you has filed a Chapter 7 proceeding. “Wow,” you think; “We just made it in! Were we ever lucky to receive payment when we did.”

You hear nothing else for months, or a year, or up until *two or more years later*¹ when you receive a letter from your debtor's Chapter 7 Trustee (who was appointed by the Court, as you will remember) as follows:

It is our understanding that you received a payment from the Debtor in the amount of \$X on XX/XX/2009. As this payment was made within ninety days of the date of the Debtor's filing of a bankruptcy petition, the payment to you is deemed a preferential payment and is avoidable. Please return this payment within ten days or litigation will be commenced against you.”

Why should you have to give this money back? After all, you were owed the money fair-and-square. There was no question as to the validity of the debt, and for that matter, the payment you received didn't even zero out the account – there still remains an unpaid balance owed to you. Clearly there must be a mistake...

The answer is: Maybe and maybe not. In this article, we will try to explain the law and the reasoning behind the Trustee's request for repayment, and also to provide information about defenses you may have to the Trustee's claim.

First, what exactly is a preference payment? Bankruptcy statutes define a preference as follows:

¹ The applicable statute of limitations permits the Trustee to file an action to avoid a preferential payment for up to two years from the date of the filing of the petition, or one year from the date of his appointment, whichever is later. *11 USC §546.*

- 1) The transfer of an interest of the Debtor in property;
- 2) To or for the benefit of a creditor;
- 3) For or on account of an antecedent debt² owed by the Debtor before such transfer was made;
- 4) Made while the Debtor was insolvent (the Debtor being presumed to be insolvent within the 90-day period preceding the filing of a petition); and
- 5) Made within 90 days before the filing of the bankruptcy petition (or within one year if the creditor was an insider);
- 6) That enables the creditor to receive more than such creditor would have received in the case were a Chapter 7 liquidation proceeding. *11 U.S.C. §547.*

The last of these points probably best explains the reasoning behind granting a Trustee the right to void a transfer as a preference. Remember that in bankruptcy liquidation, creditors' claims are paid on a statutorily-ranked basis. The bankruptcy statutes dictate who is paid and in what amounts. If a pre-filing transfer permits one creditor to receive more than he would otherwise receive, that creditor is receiving preferential treatment over all creditors similarly situated – and that situation is exactly what the preference provision of the Bankruptcy Code seeks to prevent.

The vast majority of preference cases involve a payment by the bankrupt debtor to a creditor within 90 days of the date of the filing of the bankruptcy petition. So what do you do if you receive a letter from a Trustee demanding the return of payment? Fortunately, all is not lost – there are several defenses available.

A common defense is known as contemporaneous exchange for new value. Under Section 547 of the Bankruptcy Code, in order to be a preference, the payment must be “for or on account of an antecedent debt.” Logically, then, if the payment is for “new value,” it is not for an antecedent debt. If, for example, you provide material and labor to an owner on a project and you are paid on a COD basis for that material and labor, a court may well consider that payment a “contemporaneous exchange” for new value, and not payment on an antecedent debt – ***even though you are owed money for materials and labor provided to the same owner on other projects.*** This defense, however, can easily and inadvertently be lost by applying the payment to aged invoices or by applying the payment to another job. In other words, your internal accounting system may cause this defense to be lost. Be sure to apply any payments to current invoices – that will better protect you from a claim for a preferential payment.

Another common defense is known as the “ordinary course of business.” This defense applies in situations where the debt was incurred in the ordinary course of business between the two parties, was paid according to the ordinary course of business between the two parties ***or*** paid according to ordinary business terms as are customary in the industry.

Although the defenses discussed above are the most commonly used, there are other defenses available such as the enabling loan exception and the subsequent new value defense. In a continuing business relationship, if you continue to work, i.e. provide value, in the ninety-day

² The term “antecedent debt” is not defined by the Bankruptcy Code, but a common sense definition applies. A debt is antecedent if it is incurred before the transfer or payment from the Debtor.

period prior to bankruptcy, many times a new value defense may be available to a portion of the preference claim.

There are a few practical strategies worth considering. First, hold on to the money as long as you can! Often demands to recover preferential payments are sent as a matter of course. It may be that the claim will be abandoned by the Trustee as not being worth pursuing. Second, if you receive a demand, try to force the Trustee to show why he believes the payment to be a preference. After all, the Trustee has the burden of proof to show that the five elements of a preference are present. Third, examine the defenses that are available to you. Fourth, remember that this is a negotiation like any other. There is a cost-benefit component to the Trustee's case. Keep that in mind when trying to work out a mutually acceptable agreement.

Preferences are but one of the many counter-intuitive, seemingly illogical aspects of bankruptcy law. If you find yourself facing a preference claim, try to learn as much as possible about the nature of the claim before you make any commitment toward payment of it. You may well be able to avail yourself of one of the defenses discussed in this article.