Guest Column: A primer on bankruptcy preference law for business owners

Payments from a customer just prior to their filing bankruptcy might have to be paid back

By **Jeremy Retherford and Madison Field** - December 6, 2022

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The land of bankruptcy can be foreign to most businesses. When a customer files bankruptcy while owing your business money, you quickly pick up on buzzwords like "pre-petition," "proofs of claim" and "the unsecured creditors committee."

Another term that pops up — but often not until months after the bankruptcy case is filed — is "preference payments." Often a business will discover this term upon receiving a letter demanding you return money to a customer that paid your business in the short term before that customer filed bankruptcy.

Dealing with an unpaid balance plus the possibility of being required to return money that previously and rightfully was paid leaves many in a state of shock. As a business owner, if thoughts of unfairness are running through your mind, you wouldn't be the first. While this article does not debate the fairness of federal bankruptcy law, it does breakdown the concept of "preference payments" so that you and your business can be better prepared should you ever face a lawsuit seeking the recovery of payments.

Two fundamental goals of federal bankruptcy law are to (1) provide a fresh start to a debtor and (2) ensure creditors in a similar situation are treated equally. One way the second goal is achieved is for creditors to be put in certain classes based on the nature of their debt. For example, a trade creditor with no collateral will be classed with other "general unsecured creditors." Creditors in the same class receive the same type of payment. In the typical bankruptcy case where not enough assets exist to pay general unsecured creditors in full, each creditor typically receives the same pro rata share of a certain pool of assets based upon the amount of the creditors claim.

This seems fair, right? But what if a customer files bankruptcy after not paying you for months, and you are told you will receive only pennies on the dollar for your claim and later learn that another creditor — perhaps one of your competitors — was paid a huge chunk of its outstanding debt just weeks before the bankruptcy case was filed? The money used to pay that vendor would have otherwise been part of the bankruptcy estate used to pay creditors like you. Suddenly, the situation doesn't seem as fair does it?

To address this scenario and to help ensure equal treatment for creditors, bankruptcy law says "preference payments" like the one described in this scenario can be clawed back from a creditor and returned to the overall pool used to pay creditors. Setting aside legal jargon and nuances, a payment constitutes a preference if the soon-to-be-debtor made the payment to the creditor within 90 days of filing bankruptcy for a debt that arose before the payment was made. This relatively straightforward concept addresses the inequitable situation where one creditor receives substantial payments shortly before a bankruptcy filing. But in doing so, it creates a whole new set of issues: in some instances, it is inequitable to force a creditor to return a preference payment. To address this, bankruptcy law provides several defenses a creditor can use to prevent a claw back. The two most-commonly asserted of these defenses are the "ordinary course defense" and the "new value defense."

To prevail under the ordinary course defense, the creditor must show the payment that would otherwise constitute a preference payment was made consistent with other payments made by the debtor. To prove this a payment history for approximately 1 to 2 years is reviewed and a baseline or range is established as to what the ordinary course was leading up to the 90 days before bankruptcy (known as the "preference period"). Payments made during the preference period that are consistent with this baseline are protected. Those that are not are subject to being returned. For example, if in the one year before the preference period payments were made on average 32 days after the invoice was issued, payments made within 27-37 days of the invoice date likely would be protected. Payments made 2 days or 102 days after the invoice date likely would not be because they fall outside what had become the ordinary course of business between you and your customer.

The new value defense recognizes that a creditor should not be discouraged from continuing to do business with a customer who may be headed into bankruptcy and therefore allows a credit, in essence to reduce preference liability. For example, if a customer made a $100 payment to a creditor on Monday and the creditor made another shipment of widgets worth $30 on Wednesday, but the customer filed bankruptcy on Friday, the creditor's preference liability would be limited to $70 ($100 – $30 = $70).

All of this seems logical in the abstract. However, when your business faces a lawsuit to recover preference payments, you care very little about furthering the policy of ensuring fair and equitable treatment of all creditors in a bankruptcy case. Instead, you want to hold onto to any money your customer paid you before it filed bankruptcy. The good news is the defenses discussed above often allow a preference claim to be settled for far less than the original amount sought. Of course, every case is different.

The potential for preference liability should not necessarily dictate major business decisions, but it should be kept in mind. Though outside the scope of this article, steps can be taken to mitigate preference risks. If your customer files for bankruptcy, it is a good idea to run a quick analysis to see what payments could be subject to a preference claim and what defenses could apply. While there may be nothing a business can do immediately, alerting your management team of the potential risks will help avoid surprises in the future. And if the day comes when your business receives a letter demanding the return of a preference payment, do not panic! Immediately consult a bankruptcy attorney and provide them with the records needed to assess liability. With the right set of facts, a real possibility exists that early settlement can be reached.

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