

THE PREFERENCE PAYMENT PICKLE

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With the recent wave of bankruptcy filings by automotive suppliers and non-suppliers alike, chances are, your clients may be affected by the ever more common conundrum known as the preference payment. Here is the common situation. Your client has recently called and harassed one of its customers into paying a months old invoice for goods shipped quite awhile ago which terms were originally net 30 days, for example. One month after receiving the payment, your client learns that his customer has filed for bankruptcy protection under Chapter 11 of the Bankruptcy Code (the “Code”). The smile your client was sporting for having been paid should be all but gone at this point. This is the classic preference payment problem. There has been a transfer of the debtor’s interest in property to or for the benefit of a creditor, for or on account of an antecedent debt owed by the debtor before the transfer was made, and was made while the debtor was insolvent, and made within 90 days¹ before the bankruptcy petition was filed, which transfer enabled the creditor to receive more than the creditor would have received if the case proceeded under Chapter 7 of the Code. 11 U.S.C. 547. To make matters worse, the debtor is presumed to be “insolvent” during the 90 days preceding its bankruptcy filing. 11 U.S.C. 547(f).

If the above facts are true, and your client is unable to avail itself of certain statutory and/or other defenses, the Code allows the Trustee (or Debtor-in Possession) to avoid and recover such transfers. By now, the puzzled look on your client’s face has turned into an expression of outright horror as he hands you a letter from the Trustee which demands the return of any such payments made with the 90 days preceding the bankruptcy filing. All is not lost

¹ If the creditor is deemed an “insider” (i.e. a relative of the debtor, a general partner of the debtor, a corporation of which the debtor is a director or officer) the “reach back” period for a preference goes back one year before the date of the filing of the bankruptcy petition. 11 U.S.C. 547(4)(B).

however. Upon receipt of such a demand from the Trustee, your client must begin a detailed analysis to determine whether any such transfers were indeed “preferential.” It is imperative that clients maintain excellent records to aid in such an analysis.

The first stage of analysis should focus on whether the alleged preferential transfer fits the statutory definition of a preference payment. For example, if the payment or transfer received did not come from the debtor but, in fact, came from a third party on behalf of the debtor, it is not a preference payment (i.e. it is not a transfer of a debtor’s asset). This is where the retention of good record keeping comes into play. It would be important to obtain/maintain copies of all checks representing the alleged preference payment to determine the source of the payment. Other inquiries, for example, are whether the payment received was actually on account of “antecedent” or pre-existing debt. If the payment was a “cash-in-advance” or “cash-on-delivery” situation, this is not antecedent debt.

The second stage in any such analysis requires a review of the affirmative defenses found at 11 U.S.C. 547(c). Such defenses include whether the payment was made in the ordinary course of business between the parties, 11 U.S.C 547(c)(2), or whether the creditor gave “subsequent” new value to the debtor following an alleged preferential transfer, 11 U.S.C. 547(c)(4). For the “ordinary course” defense, the creditor must be able to prove that the debt was incurred in the ordinary course of business between the parties, that the payment was made in the ordinary course between the parties, and that the payment was made according to ordinary terms used in the parties’ industry. This is the most difficult affirmative defense to prove and requires expert witness testimony as to industry payment standards. The “subsequent new value” defense allows the creditor to set-off the alleged preferential transfer amount by getting credit for additional goods shipped to the debtor following receipt of a preferential payment during the 90

day preference period. Again, good record keeping by the creditor is essential to prove any such credit. As the Trustee has up to three years to file such preference actions, it is a good idea for your client to retain such records for at least 4 years.

Since it is impossible to predict the timing of bankruptcy filings, your client can never truly avoid the preference problem. Clearly, no one should ever turn down payment on antecedent debt for fear of a possible preference issue because the transferor may never file bankruptcy or the timing of a subsequent bankruptcy filing may not qualify the payment as a preference (i.e. payment outside the 90 day preference period). However, if a client is caught in such a situation, good records will enable a practitioner to quickly pin point which payments are truly preferential and which ones may be protected.

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