Preferential payments

How to keep money paid to you by a customer that goes bankrupt

JULIE JOHNSTON-AHLEN
Of counsel
Novack and Macey LLP

(312) 419-6900
jja@novackmacey.com

WEBSITE: Visit www.novackmacey.com to learn more about this and other legal issues.

Insights Legal Affairs is brought to you by **Novack and Macey LLP**

In 2012, more than 40,000 businesses filed for federal bankruptcy protection. When this happens, the bankrupt entity or the bankruptcy trustee will sometimes seek to recover certain payments previously made to the bankrupt entity's creditors so that those funds can be redistributed in accordance with the U.S. Bankruptcy Code. One type of payment that the bankrupt entity or the trustee may seek to recover is called a preference.

Smart Business spoke with Julie Johnston-Ahlen, of counsel at Novack and Macey LLP, about how to deal with being sued for preferential payments.

What is a preference?

A preference is a transfer or payment on an existing debt. It's made by a soon-to-be bankrupt debtor to a creditor within the 90-day period preceding the bankruptcy filing.

Why can't you keep the money that the bankrupt entity paid you?

The purpose of the law on preferential transfers is to try to make the bankruptcy process as fair as possible for all of the bankrupt entity's creditors. When a business has insufficient cash flow, it will often pay certain creditors in full and not pay others, depending on which goods and services are most critical to the soon-to-be bankrupt entity's business. In an effort to maximize the fair distribution of the bankrupt entity's assets, creditors that receive preferential payments are often forced to return the money to the bankruptcy estate for redistribution, subject to the supervision of the court.

Do you have to return the money?

It depends. The bankrupt entity or trustee has the burden of proof. So, it must be demonstrated that there was a transfer or payment of property of the debtor, to or for the benefit of a creditor, on account of antecedent debt. This must occur within 90 days of bankruptcy and enable the creditor to receive more than it would in a Chapter 7 liquidation. In addition, the transfer or payment must have been made when the bankrupt entity was insolvent.

Even if these elements can be established, many creditors have viable defenses that may enable them to keep some or all of the money they received. These defenses are fact specific, and in practice, can be difficult to assert without the assistance of an attorney familiar with defending preference actions.

What should you do if you are sued for a preference?

In most cases, you have two options: you can pay back the full amount of the payment, or you can fight the claim. If you fight it, you have a good chance of keeping some portion of the payment, particularly if you can demonstrate that you have one or more viable defenses. Further, even if you don't assert specific defenses, but you make a reasonable offer of partial repayment, the bankrupt entity or trustee may be willing to settle for that lesser amount. This is particularly true in larger bankruptcy cases where the bankrupt entity may be pursing repayment from many creditors. It's often not feasible to fight with every creditor in an attempt to recover the full amount of each transfer.

Should you accept payments from a customer that might be having financial trouble?

Generally speaking, yes. There is nothing 'wrong' with accepting a payment that turns out to be a preference. You just might be forced to pay the money back later.

Creditors are almost always better off accepting payment from the future bankrupt entity, and then later dealing with any efforts it makes to recover the money. Again, it is often the case that the bankrupt entity or trustee will settle the claim for less than the full amount of the payment. The creditor keeps the rest, and it's almost always the case that it ends up recovering more money than if it had not received the payment. ●