Financial Recovery Law

Recovery? Depends on Your Preference.

By: Bill Gray. ***This was posted Friday, July 16th, 2010***

The economy continues to struggle to mount a real recovery. Economists and banking experts argue about how to maintain the little bit of momentum we've seen over the last six months. From our view as Virginia creditors rights lawyers, we think there is a coming wave of preference claims that will surprise a lot of companies that were thanking their lucky stars that they had collected their accounts due before customer X, Y and Z had filed for bankruptcy.

Probably the hardest thing for a bankruptcy attorney to explain to his or her corporate client is the concept of a bankruptcy preference claim. The common refrains are: "You have to be kidding me!" "I received a payment and now I have to give it back!!?" "They owed us this money, so why do we have to give it back?"

With the wave of bankruptcy filings in the past couple of years, and a two year statute of limitations for bankruptcy preference actions, corporations, or individuals, may unfortunately find themselves faced with this unpleasant situation and wondering "how can this be?" The legal answer is not really what clients want to hear: the Bankruptcy Code specifically allows a bankruptcy trustee to sue companies or individuals that have received a payment from a debtor within 90 days before the bankruptcy was filed. If someone is an "insider" of the debtor — e.g., an owner of the bankrupt company — the "reach back" period is an entire year.

But that does not answer the question of "why?" The "why" is embedded in the word "preference". One over-riding principal of bankruptcy is that there should be a fair and equitable distribution to all similarly situated creditors of a debtor. Coupled with that is a requirement that a debtor must list, in the bankruptcy schedules they must file, anybody and everybody to whom they owe money. When a company knows it must file bankruptcy, they could easily circumvent the requirement of listing all creditors, by paying certain "preferred" creditors before the bankruptcy filing. If the debtor does not owe someone on the day the bankruptcy is filed, then they would not have to list that creditor in the schedules. So, a debtor could — using scarce resources — pay favored vendors, or friends, or family members — in full, before the bankruptcy is filed. Then they file the bankruptcy, and all other creditors who were not paid before the bankruptcy end up on the short end of the stick. That is not fair or equitable, nor is it equal treatment to all like-creditors.

To remedy this, or prevent this from happening, the Bankruptcy Code put in the preference statutes. In essence, creditors who receive the preference payments are drawn back in to the bankruptcy case, to even the playing field with all other creditors.

Admittedly, this explanation seldom satisfies clients. Fortunately, even though a payment was received within 90 days of the bankruptcy filing, the debtor still must prove several elements (e.g., exactly when the payment was made; the existence of an antecedent debt; etc), and there are numerous defenses to the claim that can be asserted. Two of the most common defenses are “ordinary course” payment, and “subsequent new value.” The ordinary course defense is, basically, an argument that there was nothing out of the ordinary in the payment that was made and/or received, and thus the payment was not meant to “prefer” someone. The subsequent new value defense looks at transactions between the parties after the alleged preference payment was made. If a creditor, subsequent to the alleged preference payment, give some “new value” to the debtor (e.g., extends new or more credit to the debtor), then that would be a defense to the preference claim.

Quite frankly, another difficult discussion to have with a client about a preference claim is the cost to defend the claim. Fact is, it can be expensive to prove “ordinary course” or “subsequent new value.” If the trustee is seeking $5000, and it will cost that much to litigate a defense of the claim, why bother?

However, the trustee prosecuting the case has similar expenses, costs and risks. And, it is in the trustee’s interest to resolve matters as quickly, and inexpensively, as possible. Because of this, the vast majority of “low dollar” amount preference claims are settled, without going through expensive litigation. An experienced bankruptcy attorney can often quickly analyze the facts, and informally discuss with the trustee a settlement — before all-out litigation and costly litigation ensues. Often, the client saves money (even after paying their attorney to negotiate the settlement). The key to low dollar preference claims is to act quickly. Certainly, a preference claim should not be ignored. As strange as it may sound, it is best to attempt to settle a a preference claim right away.

Of course, if a preference claim is 5 or 6 figures, it is imperative that counsel be retained, and defenses asserted. But even in this case, the end result is often savings for the client.

What are you doing to prepare your business for the possibility of losses like these? Are there some claims too small for you to bother with? What is your threshold and why?