Bankruptcy Preference Claims Against Creditors

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Recently a growing number of clients have sought our advice after receiving demands to pay back alleged preferential payments received from customers in bankruptcy. This is particularly so in the case of clients that provide goods or services to financially troubled companies. Clients are often surprised that payments received from a struggling entity may not be theirs to keep if the entity files for bankruptcy within 90 days after making the payment (or within one year in the case of insiders).

Under the Bankruptcy Code, the bankruptcy trustee (or the debtor itself as the "debtor-in-possession" or "DIP" in a Chapter 11 reorganization case) may seek return of any payments made to the debtor’s unsecured creditors within the 90 days prior to bankruptcy, under certain circumstances. These payments are referred to as preferential payments. The power to recover preferential payments is one of the “avoidance” powers given to bankruptcy trustees and DIPs by the Bankruptcy Code. These powers are designed to meet one of the primary goals of bankruptcy law, which is to insure that a debtor’s unsecured creditors are treated equally and, to some extent, neutralize the rash of collection actions within 90 days before bankruptcy. Preferential payments recovered by the trustee or DIP go into the bankruptcy estate. Any funds remaining in the estate after payments of secured and priority claims, such as taxes and the costs of the bankruptcy administration, are ultimately distributed pro rata to the debtor’s unsecured creditors.
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Definition of Preference

Payments within 90 days prior to the date of the debtor’s bankruptcy to unsecured creditors are presumed to be preferential in that those creditors are being “preferred” by the debtor over other creditors who did not receive payments in that period. Specifically, a preference is:

- a payment to, or for the benefit of, the creditor
- for, or on account of, an existing debt
- made while the debtor was insolvent (the debtor is presumed to be insolvent during the 90 days prior to its bankruptcy)
- made at any time during the 90 day period before the bankruptcy filing
- resulting in the creditor receiving more than it would receive in a Chapter 7 liquidation

Payments to secured creditors are generally not preferential since the secured creditor is entitled to receive the value of its collateral which, in most cases, is more than the payment received by the secured creditor. An unsecured creditor may be liable for return of some or all of the preferential payment, unless the creditor can show the payment falls within one of the preference exceptions or defenses enumerated in the Bankruptcy Code.

In large bankruptcies, trustees or DIPs commonly issue blanket preference demands to every unsecured creditor who received payment within the 90-day window, with little (or arguably insufficient) analysis of applicable exceptions. Also, in large chapter 11 cases, a Plan of Reorganization may provide for the appointment of a liquidating trustee, who will attempt to recover as many preference dollars as possible. In smaller cases, the DIP or trustee does not always demand the return of preferential payments. That is why we always advise clients to accept customer payments even if they expect that the customer may soon be in bankruptcy.

Defenses to a Preference Claim

The three most common defenses, or exceptions are:

- the payment was not for an existing debt but was a “contemporaneous exchange” of new value (e.g., goods or services) for the payment
- after the payment was made, the creditor gave the debtor “subsequent new value” by providing more goods or services for which the debtor did not make another avoidable transfer
- the payment was made in the “ordinary course of business” of the debtor and the creditor, or was made according to ordinary business terms
Proof of Defenses

Under the Bankruptcy Code, a creditor who receives an alleged preferential payment bears the burden of showing that some or all of the claimed preferential payment falls within one of the stated exceptions and is not recoverable. But some courts, in response to a recent Supreme Court case, have begun to require trustees or DIPs to make specific allegations about claimed preferences before putting this burden on the creditor.

The location of the bankruptcy may have an impact on the outcome of a preference claim – bankruptcy courts in different districts are not always in accord as to what constitutes appropriate proof of various preference defenses, or as to the existence of other exceptions for unsecured creditors. For example, there is a split among the districts about whether new value given by a creditor must remain unpaid by the debtor in order for the creditor to prevail on a subsequent new value defense. Some courts disagree as to whether a trade creditor’s claim for goods provided to a debtor within the 20-days prior to bankruptcy (which claim has priority status under the Bankruptcy Code) can be subject to the trustee or DIP’s right to claim a preference. One court has held that the goods covered by such a 20-day priority claim may also be the basis of a subsequent new value defense, while a court in a different district has indicated it would view 20-day priority claims and subsequent new value defenses relating to the same goods as impermissible “double dipping.”

Proof of preference defenses can be highly technical and requires detailed analysis of the parties’ previous history, course of dealings, and the ordinary practices of the particular industry...
Resolution of preferences claims can be complicated. Our experienced bankruptcy attorneys have defended these claims on behalf of many creditor clients throughout the United States by negotiation and, where necessary, litigation in the bankruptcy courts. Feel free to contact any of our Bankruptcy attorneys for additional information about preference claims, the defenses against them, strategies to avoid such claims, or any other questions about creditors’ rights, bankruptcy, reorganizations, or work-outs outside of bankruptcy.

Stanley Salus, a shareholder in the firm’s Tysons Corner office, regularly represents banks as secured and unsecured creditors in bankruptcy proceedings and advising clients on all phases of Chapter 11 reorganizations, on both the debtor and creditor sides.

Mona Murphy is Of Counsel in the firm’s Tysons Corner office and represents commercial clients in bankruptcy matters, in federal and state court proceedings, and in all aspects of business transactions, organization and governance.

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