

Preference payments

How you might have to return a payment to a company that files for bankruptcy

INTERVIEWED BY JAYNE GEST

A “preference action” is a lawsuit by or on behalf of a debtor seeking to recover certain payments made by the debtor prior to filing for bankruptcy. Preference actions are unfamiliar to many business owners and often seem illogical and unfair.

“Clients often receive a letter demanding the return of a payment that the debtor made to them before filing for bankruptcy. They call and say, ‘What does this mean? Do I have to return this money? We sold them products and they paid us, are they entitled to get their money back?’” says Stephen C. Goldblum, member at Semanoff Ormsby Greenberg & Torchia, LLC. “The answer is yes, you may have to return the money — unless the payment falls within one of the statutory defenses.”

Smart Business spoke with Goldblum about how preferences work.

What should you know about preferences?

Typically, a preference action is often preceded by a ‘demand letter’ from the debtor demanding the return of payments made in the 90 days prior to the debtor filing for bankruptcy. This seems patently unfair to the recipient of the payment. The business provided products or services and was paid for them, and it seems unjust to have to return the money, often many months after the payment was received. The policy behind the bankruptcy code, however, takes a broader view. The policy is to prevent debtors from treating creditors unequally and paying preferred creditors before filing bankruptcy, and to prevent aggressive collection activities that could actually force a debtor into bankruptcy. Such policies have been determined to be of greater importance than the rights of an individual creditor.

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There are four elements needed to prove a preferential payment; if the payment was:

- For an antecedent (previously incurred) debt.
- Made while the debtor was insolvent.
- Made to a non-insider creditor in the 90 days prior to the bankruptcy filing.
- Allows the creditor to receive more than it would have if the payment had not been made and the claim paid through the bankruptcy proceeding.

Where do many businesses make mistakes regarding preferences?

A business’ biggest mistake is to ignore a demand letter received by or on behalf of a debtor. Often the debtor is willing to settle the preference claim for a significantly reduced amount before a lawsuit is filed. A business that ignores a demand letter or fails to timely retain counsel familiar with bankruptcy law often misses its best opportunity for a favorable resolution.

Do you receive the repayment back?

Usually not. The preferential payments recovered by the debtor are added to the bankruptcy estate. To the extent there are funds available, secured, priority and certain other creditors are paid first. To the extent there are funds remaining, they are distributed to the unsecured creditors, which often results in little or no payment.

What are the defenses when a payment is alleged to be preferential?

The three primary defenses to an alleged preferential payment are the following:

- New value defense, which provides an offset against the preferential payment if the creditor subsequently gives new value to the debtor after the alleged preferential transfer.
- Ordinary course of business defense, which protects transfers consistent with the debtor and creditor’s prior business history.
- Contemporaneous exchange defense, which includes certain concurrent transactions such as a cash-on-delivery.

How are insider creditors treated differently?

With insiders — corporate officers or directors, relatives and related entities — a debtor may recover payments for up to 12 months prior to the bankruptcy.

How can you protect your company?

It’s difficult for a company to pre-emptively protect itself from a payment later being deemed preferential. When you receive a letter demanding return of an alleged preferential payment, contact an attorney experienced with creditors’ rights. He or she will analyze the potential defenses and prepare a response to the letter. Often, a timely, well-reasoned response to a demand for the return of a preferential payment leads to a prompt and cost-effective resolution. ●