

Preference claims

Do you need to return payments to a company that files for bankruptcy?

A preference claim is a demand by or on behalf of a debtor seeking to recover certain payments made by the debtor prior to filing for bankruptcy. This demand is 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 the client before it filed for bankruptcy. They call and say, ‘Do I have to return this money? We provided products and services and they paid us. Are they really entitled to get their money back?’” says Stephen 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 preference claims work.

WHAT ARE PREFERENCES?

Typically, a preference claim begins with a ‘demand letter’ on behalf of the debtor demanding the return of payments made in the 90-days prior to the debtor filing for bankruptcy.

The policy behind the bankruptcy code provisions that may require the return of such payments 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.

There are four elements to a preferential payment. If the payment:

- Was for an antecedent (previously incurred) debt.

Stephen C. Goldblum

Member
Semanoff Ormsby Greenberg & Torchia, LLC

215.887.5961
sgoldblum@sogtllaw.com



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- Was made while the debtor was insolvent.
- Was 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 was paid through the bankruptcy proceeding.

WHAT ARE THE DEFENSES WHEN A PAYMENT IS ALLEGED TO BE PREFERENTIAL?

The three primary defenses to an alleged preferential payment are:

- 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.

WHERE DO BUSINESSES MAKE MISTAKES REGARDING PREFERENCES?

A business’s 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 an extremely 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.

COULD 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.

HOW CAN YOU PROTECT YOUR COMPANY?

It’s difficult for a company to preemptively 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. The attorney 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. ●