

Preferential Payments in Bankruptcy Do We Really Need to Be Worried About Them?

The economy, based on the news and our pocketbooks, is going through hard times. That means that more companies are filing bankruptcy. A common question posed to me by both my professional friends and clients is whether or not payments they have received from a company that has filed a bankruptcy are subject to recovery as preferences.

In general, a "preference" exists when a debtor makes a payment or other transfer to one or more, but not all, creditors. While, outside of bankruptcy, there is nothing illegal or improper about that, in bankruptcy such favoritism is prohibited. The preference sections of the Bankruptcy Code impose upon the debtor an obligation to treat its creditors fairly once the threat of an impending bankruptcy becomes apparent. To implement this policy, §547(b) of the Bankruptcy Code permits a bankruptcy trustee to avoid certain pre-bankruptcy transfers as preferences. The debtor's intent or motive is irrelevant as to whether a preference exists. Generally speaking, it is the effect of the transaction, rather than the debtor's intent, that matters.

Elements of a Preference

In order for a payment to be recovered as a preference, the following tests must be met:

1. A transfer of an interest of the debtor in property;
2. To or for the benefit of a creditor;
3. For or on account of an antecedent debt owed by the debtor before the transfer was made;
4. Made while the debtor was insolvent;
5. Made within 90 days prior to the filing of the bankruptcy petition, or made within one year prior to the filing of the bankruptcy if the payment was to an insider;
6. Enables the recipient to receive more than the recipient would have received if the case were a Chapter 7 liquidation.

Some discussion of each of these elements follows.

1. Transfer of an interest of the debtor in property.

This definition is intended to be as broad as possible, whether the transfer is by means of a direct payment, the creation of a lien, or even a foreclosure, whether voluntary or involuntary. Accordingly, this definition would include the simple payment by debtor of a creditor's bill, as it would include a judgment lien obtained by a creditor from a court of law.

2. To or for the benefit of a creditor.

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About Brian Davidoff



Brian is the firm's Managing Partner and is certified in Business Bankruptcy Law by the American Board of Certification. He has expertise in all aspects of insolvency and reorganization matters. In addition to insolvency matters, a substantial portion of Brian's practice focuses on counseling emerging and mature business entities in various aspects of their growth, financing, contractual relationships and operations. He has represented clients in a variety of industries, including manufacturing, retailing, real estate, technology and entertainment. Brian can be reached at bdavidoff@rutterhobbs.com or by telephone at

A "creditor" is an entity that had a claim against the debtor that arose before the filing of the bankruptcy. The fact that one needs to be a "creditor" of the debtor demonstrates that not all payments made within the prescribed look back time period are preferences. If the recipient is not a pre-existing creditor at the time of payment, then, while the payment may be improper for some other reason, it is not a preference.

3. For or on account of an antecedent debt.

An antecedent debt is a debt that existed before the transfer was made. The distinction here is to avoid favoritism among the debtor's creditors of who will get paid first. The delivery of goods contemporaneous with the receipt of a payment is not a preference since, at that time the recipient of the payment is neither a creditor nor has the payment been made on account of an "antecedent" debt.

4. Made while the debtor was insolvent.

The transfer must have been made while the debtor was insolvent. Insolvency means that the debtor's debts are greater than the fair value of all of its assets. A rough balance sheet test is the determining factor of whether insolvency exists.

5. Within the reach back period.

The transfer must have occurred within 90 days prior to the filing of the bankruptcy petition or, if the transfer was to an insider, then made within one year prior to the bankruptcy petition. What happens however, if an obligation is guaranteed by an insider? For example, what if the principal of a company guarantees the debtor's bank and the bank is paid more than 90 days, but less than one year, prior to the bankruptcy filing? In this case, the transfer may be set aside as a preference only as to the insider guarantor. Insiders include those you might suspect: for corporations - officers, directors and controlling shareholders; for partnerships - general partners; and, for individuals - members of the individual's family.

6. Resulting in a greater distribution than in a Chapter 7.

In order to be set aside as a preference, the transfer must result in the creditor receiving more than the creditor would in a Chapter 7 liquidation. This means that secured creditors who are entitled to receive their property in a Chapter 11 or a Chapter 7 are usually likely to be exempt from the preference sections of the Bankruptcy Code.

Defenses

Even assuming that the transfer satisfies all of the above tests, recipients in business transactions can rely on some well established defenses to preferences.

1. Contemporaneous Exchange Defense.

A payment may not be recovered as a preference to the extent that the payment was intended by the debtor and the creditor to be a contemporaneous exchange for new value and, in fact, was a substantially contemporaneous exchange. Thus a transfer which would otherwise be considered to be preferential is insulated from attack if (1) the recipient extended new value (such as delivery of new product, or for example, the release of a lien) to the debtor, (2) the recipient and the debtor intended the new value and reciprocal payment to be contemporaneous, and (3) the exchange was in fact contemporaneous.

2. Payments in the ordinary course of business.

A trustee may not avoid a transfer to the extent that the transfer was in payment of a debt incurred by the debtor in the ordinary course of business between the debtor and the transferee and made according to ordinary business terms. Courts have interpreted this requirement by

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examining whether there was anything "unusual" about the underlying transaction. For example, courts examine the length of time that the parties were engaged in business, whether the amount or form of the transaction differed from past practices, whether the debtor and creditor engaged in any unusual collection or payment procedures, and other relevant circumstances.

3. Transfers for subsequent new value.

The trustee may not avoid a transfer to the extent that, after the transfer, the recipient gave new value to the debtor. In other words, even though a creditor has received a preference payment, the creditor may still offset the preference against any subsequent, unsecured credit that the creditor provided to the debtor after receipt of the payment. New value is defined as money or money's worth in goods, services or new credit or the release by a transferee of property previously transferred.

Ordinarily, in evaluating the new value defense, an analysis is undertaken of all of the debit and credit transactions between the debtor and the creditor until a final balance is established prior to the bankruptcy.

Conclusion

Defendants rank preference suits among the most unwelcome of all litigation. Not only is the defendant usually already unpaid for goods or services provided to the bankrupt company, but now a demand is made on them for a further recovery. A proper analysis of the claims and defenses can yield an improved outcome.

The bankruptcy group at Rutter Hobbs & Davidoff represents clients in defending preference and other avoidance actions by trustees.

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