



Are Your Customers Going Bankrupt? Don't Throw Away More Good Money

By Corey Taylor

Sadly, when customers file for bankruptcy, their creditors are often left with sizeable accounts receivable. Even worse, after the customer/debtor files for bankruptcy, the bankruptcy trustee can – and often does – seek reimbursement from the creditor for funds recently paid to the creditor by the bankrupt business. In other words, not only must the creditor write off a bad debt, it may actually *owe* money to the bankrupt debtor! Obviously, this problem is particularly troubling to small and medium sized business owners.

This article explores why the foregoing occurs and offers advice on how to prevent being stuck in this unfortunate situation. At the very least, the article should help you maximize recovery should the bankruptcy trustee come after your business for a so-called “preferential transfer.”

The Scenario

To illustrate how preferential transfers work, let's look at an example: Your business is a provider of widgets. You have been providing widgets to your loyal customer, BK Co. (“BK”), for several years. Over the past six months, however, BK's receivable with your business has grown increasingly larger. Suddenly, you receive a notice mailed from the United States Bankruptcy Court informing you that BK is in Chapter 11 reorganization. As a result, you know that you are only likely to receive a fraction of the amount BK owed to your business, if anything at all. Nevertheless, you submit a claim to the bankruptcy estate for the outstanding receivable BK owes.

Several months later, the situation worsens – the bankruptcy trustee serves your company with a lawsuit claiming that the payments BK made to your business for goods sold to BK within 90 days prior to filing for bankruptcy protection must now be repaid.

How can this be? BK owes *your* company yet the bankruptcy trustee is asking you to pay back BK? What the heck is going on?

The Law of “Preferential Transfers”

Federal bankruptcy law attempts to set aside “preferential transfers,” *i.e.* payments made to those creditors the debtor prefers to pay directly before making payments to other creditors who are entitled to first payment as a matter of legal priority (*e.g.* secured creditors). An entity filing for bankruptcy protection is presumed to have been insolvent for 90 days before the actual date of its bankruptcy filing. 11 U.S.C. § 547(b). Money paid by the bankrupt entity during that 90 day period is deemed to be a “preferential transfer.” In other words, the bankruptcy court *presumes* that payments made during this 90 day period were made as a favor to the other business entity so that entity did not have to “wait in line” with the other secured and unsecured creditors. Thus, in a “preference” action the bankruptcy trustee seeks to recover payments made during this 90 day period for distribution to other creditors according to the particular bankruptcy plan. This is why your business can be subject to the “double whammy” of your customer's bankruptcy.

Fortunately, there are several exceptions to the so-called “preferential transfer” rule.

Exceptions to the Rule

The three most common defenses/exceptions are the “contemporaneous exchange,” “ordinary course” and “subsequent new value” exceptions. Unfortunately, because transfers made during the 90 day “preference” period are *presumed* to be preferential, the burden to establish one or more of these exceptions falls upon the creditor/defendant in the preference action. 11 U.S.C. § 547(a). In other words, you will

need to prove that the money that your business received was *not* a preferential payment.

1. Contemporaneous Exchange

This exception requires that both the debtor and the creditor intend to, and actually do, contemporaneously exchange goods or services for money during the preference period. 11 U.S.C. § 547(c)(1). Using our scenario above, if your company provided widgets to BK “C.O.D.,” during the 90-day “preference period,” that transfer would likely constitute a contemporaneous exchange.

2. Ordinary Course of Business

This exception means precisely what one would expect – transactions between the creditor and debtor during the “preference period” that occur on the same terms as they did before the “preference period” are excepted from the rule. Availing oneself of this exception requires proof that the debtor incurred the debt in the ordinary course of business, that the debt was made in the ordinary course of business of both the debtor and the creditor, and that the transfer was made according to ordinary business terms. 11 U.S.C. § 547(c)(2).

Again, using the scenario set forth above, assume BK is on net 30 day terms to pay for widgets provided by your company. Over the course of the past several years BK has paid its invoices within five calendar days of this 30 day period. Under these facts, any additional transfers that occurred during the 90 day “preference period” comporting with the same payment pattern could not be recovered by the bankruptcy trustee.

However, any material variance from the pre “preference period” transaction history during the “preference period” will often defeat this defense. That is to say that if BK traditionally paid via check, a cashier’s check received during the preference period may sufficiently negate the “ordinariness” of such transactions.

Moreover, if your company’s payment terms differ substantially from those of others in your same line of business, that, too, may be grounds for not applying this exception. This is because successful application of the “ordinary course of business”

exception requires that the transfers at issue be both *subjectively* ordinary (*i.e.* normal as between the debtor and the creditor based on past history between the two) and *objectively* ordinary (*i.e.* the method and timing of the transfer is standard in the industry as determined by expert testimony).

Finally, it must be noted that the courts have a great deal of leeway in how they apply this exception/defense. Fortunately, California’s bankruptcy courts are among the more lenient in determining whether or not a transfer constitutes one made in the “ordinary course,” and thus are more likely to overlook slight variances in payment terms.

3. Subsequent New Value

The subsequent new value defense is a formulaic one. It provides that, to the extent that the creditor extended additional credit (*i.e.*, provided goods or services) to the debtor after the debtor owed money to the creditor, the amount of that so-called “subsequent new value” can be deducted from the total preference amount up to the limit of the previous transfer.

Let’s look at another example: During the preference period, you receive a \$10,000 payment for widgets shipped to BK three days prior. Thereafter, BK orders another \$10,000 worth of widgets. BK then immediately files for bankruptcy protection. Your company’s final shipment of widgets to BK (even though they have not been paid for) can be used to offset BK’s prior \$10,000 payment to your company. Thus, using the foregoing scenario, there would be no preferential transfer for the trustee to recover. Of course, your company would still have a claim for \$10,000 in the bankruptcy estate, most of which your company will likely never see again.

If, by contrast, you receive a \$15,000 payment for a prior shipment before receiving the last \$10,000 worth of widgets, your company would still have a \$5,000 preferential payment (\$15,000 less \$10,000) due to the trustee. Similarly, if BK’s last order was for \$15,000 worth of widgets and its prior payment was for \$10,000, your company would only get a \$10,000 “credit” – which is the amount of the immediately preceding transfer. Unfortunately, the additional \$5,000 cannot be “carried over” to offset any prior transfers.

This last “preferential transfer” defense also illustrates the policy underlying the bankruptcy court’s application of these three exceptions. The law encourages creditors to continue to work with financially distressed businesses in the hope that the financially distressed business can recover and not file for bankruptcy protection. Thus, providing additional goods to a distressed business, continuing to work with them in the ordinary course of business and providing goods to them “C.O.D.” favors to this policy.

How to Prevent Being Named as a Defendant in a “Preference Action”

- **Communicate.** The best advice, quite simply, is to communicate with your customers. If a payment is late or not received, contact the customer and find out their financial status. Make every effort to determine if their company is in trouble or if, for example, the payment was simply lost in the mail. The sooner you know of your customer’s financial situation, the better you will be able to anticipate its potential bankruptcy and minimize your company’s exposure.
- **Insist on C.O.D.’s.** If you suspect that your customer is in serious financial difficulty, insist on C.O.D. or other contemporaneous payments for any goods and services until and if their financial difficulties resolve. This should allow your company to avail itself of the contemporaneous exchange defense should your customer file for bankruptcy.
- **Conduct business as usual.** Once you learn that your customer is having financial difficulties, make every effort to ensure that they continue to pay you in the manner and along the same timeline as they always have. Again, even if payment that is five days later than any pre-preference payment may negate the “ordinary course” defense.

- **Call a lawyer.** If a major customer begins to run behind on its payments and/or you otherwise learn that they may be encountering financial difficulties, contact an attorney familiar with preferential transfer litigation. While this is often a bankruptcy attorney, many general civil business litigation firms also have this expertise. An experienced law firm should be able to review your past transactions with the distressed customer and provide you with a prophylactic plan of attack to minimize your exposure to the bankruptcy trustee.

Conclusion

The reality, unfortunately, is this: if a significant customer of yours goes bankrupt, your company likely will share in that financial distress to some degree. However, by following the simple rules set forth above, you can effectively minimize the amount of that damage and avoid months of expensive litigation.

Further Information

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