

Beware of Bankruptcy Clawback Suits

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As many recipients of funds and other consideration have undoubtedly experienced when dealing with a bankrupt customer, a bankruptcy filing by the customer places at risk of disgorgement the payments made by the customer prior to its bankruptcy filing date. Pursuant to what is commonly called a "preference action" or a "fraudulent transfer action," the trustee or debtor in possession may seek the return of any payments made by the debtor within the 90 days prior to the bankruptcy filing date (or 1 year for insiders) so that, the theory goes, all unsecured creditors are treated similarly in terms of distributions.

Preference actions are not brought as a result of any alleged wrongdoing on the part of the creditor, but are rather intended to carry out the bankruptcy policy to treat similarly situated creditors fairly and equally. Relatedly, preference actions seek to avoid the depletion of the bankruptcy estate by the debtor in anticipation of the filing for the benefit of certain preferred creditors. Vendors must therefore be aware that, unless proper precautions are taken, they may be forced to return payments received during the 90 days (or 1 year for insider recipients) preceding a bankruptcy filing in exchange for a mere fraction of that amount. This article provides an overview of the proactive steps vendors can take to minimize their exposure to preference actions.



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What is a Preference?

The Bankruptcy Code defines a [preference](#) as:

1. the 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 such transfer was made;
4. made while the debtor was insolvent;
5. on or within 90 days before the filing of the bankruptcy petition (or within one year before the filing if the transferee creditor is an insider);
6. that enables the creditor to receive more than such creditor would have received if the case were a Chapter 7 liquidation proceeding.

A preferential transfer may be in the form of a payment, the grant of a lien or any transfer of a property interest, and may even take the form of a transfer to a third party for the benefit of the creditor. Because the majority of bankruptcy proceedings result in distributions to unsecured creditors below their actual claim amounts, any 100 percent payment made during the preference period will pay the creditor more than it would have received in a Chapter 7 liquidation scenario. Such payments are therefore susceptible to a preference challenge.

Ways to Protect Yourself from Preference Exposure

1. Monitor the Financial Condition of Your Buyers - You should do your best to keep tabs on the financial condition of your customers and conduct your affairs accordingly. Maintain credit files of your customers, including credit application, contract, financial statements, notes, and all correspondence exchanged during the course of the business relationship. Keep watch for any signs of financial distress and upon revelation of any such signals, take precautionary measures to protect your firm from preference exposure and, more importantly, further losses. Such measures, as explained below, should include adherence to normal business practices, avoiding inconsistent or erratic payment schedules, and, whenever possible, requiring contemporaneous exchange for value. Moreover, you should not extend credit to a financially distressed buyer when a bankruptcy filing is imminent. Each of these measures may reduce the likelihood of a payment being labeled "preferential" or provide you with various defenses to preference challenges.

“ Payments received in the ordinary course of business in accordance with ordinary business terms are not considered preferential. ”

2. Maintain Ordinary Course - Payments received in the ordinary course of business in accordance with ordinary business terms are not considered preferential. To establish an ordinary course of business payment, you need only show that the payment was received in the ordinary course of the debtor and your business, or in accordance with terms common in your particular industry. You should therefore be mindful to establish and adhere to a

consistent payment schedule and be wary of sporadic or abnormal payments. Be aware of industry standards and seek to maintain a payment schedule that conforms to such practice.

To constitute payments deemed to be made in the "ordinary course of business," the payments need not be done in accordance with contract or invoice terms. Rather, the focus is on the history of the dealings between the parties and whether payments received during the preference period fit that mold. In order to defend against any allegations of preference, you should keep detailed accounts of dealings with your customers, i.e. payment history, statement of unpaid invoices, copies of invoices, proofs of delivery, payment advances and any other correspondence regarding payment terms.

If a bankruptcy filing by a customer is imminent, avoid changes in payment terms on account of past invoices, changes in the modes of payment (i.e. check to wire), changes in method of payment (i.e. regular mail to overnight courier), or collection actions such as threats to cut off shipments or a decision to enforce credit limits, as any such actions may take a particular payment outside of the "ordinary course" and vulnerable to preference attack.

3. Require Contemporaneous Exchange/Cash on Delivery - For the purpose of finding a preferential transfer, any debt that exists prior to the transfer in question constitutes an "antecedent debt" and therefore, any transfer made subsequent to the incurrence of, and on account of, such debt is vulnerable to a preference attack. As a vendor then, you should therefore request contemporaneous payment with the delivery of any goods or services. Although there is no bright line rule on what constitutes a "contemporaneous exchange," the exchange of payment for goods/services must occur closely in time and be intended and understood by the parties as such.

“ A payment that is made contemporaneously for the exchange of goods will not be considered preferential. ”

4. Take a Security Interest in What You are Selling - You protect your firm by taking a security interest in the product sold, provided the security interest is perfected within 30 days of the buyer's receipt of the property. If you are fully secured by a debtor's assets or if you are paid from the proceeds of their collateral, payments received will generally not be considered preferential and thus will not be clawed back into the bankruptcy estate.

5. Letter of Credit - Another protective measure you can take is to request that your customer provide a standby letter of credit from a bank or other entity to secure the payments for the goods and services provided. Courts have generally found that a creditor drawing on a letter of credit from the non-debtor issuer does not constitute a preference, because a letter of credit is generally not considered an asset of the debtor. Accordingly, the use of a letter of credit allows you to ensure payment of your claims from a non-debtor party without risking exposure to a preference action.

6. Subsequent New Value - You may avail your firm of the so called "new value" defense if, after the receipt of a preferential payment, you provide goods/services to the debtor. To the extent you give the debtor new value -- generally additional goods or services provided on credit -- after receipt of payment during the preference period, the request for the return of the preferential payment will be reduced by the amount of new value provided. Accordingly, if you find your firm a target of a preference action, you should review your records to determine whether you provided the debtor with goods and/or services after you received the payment.

Conclusion

There are several proactive steps that you can take to reduce your preference exposure. Those steps may reduce or completely eliminate a preference risk should a customer file for bankruptcy. While certain costs may be associated with these steps, they may be worthwhile, especially with respect to highly leveraged customers or industries considered to be in financial distress.

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