

# Recovery Of Preferential Transfers In Bankruptcy

By Josephine Yang-Paty

If you are a supplier of goods or provider of services and choose to continue to honor a long-standing business relationship with a financially distressed company, you have to beware.

If that financially distressed company subsequently files for relief under the Bankruptcy Code, you would

have potential exposure of being named a defendant in a preference action commenced by the now-bankrupt debtor or its bankruptcy trustee. You may be sued even though no wrong has been committed. Simply because of your decision to continue doing business with the debtor, you may now have to defend a lawsuit a thousand miles away in a federal district where the debtor's bankruptcy case is pending.

The lawsuit may stem from the fact that you received "transfers" (e.g., payments) during the 90-day period before the debtor filed bankruptcy. The debtor or the trustee now claims that you received payments during the 90-day period before the filing due to preferred-creditor status and sues to recover payments.

## The basis for the lawsuit

Section 547 of the Bankruptcy Code, entitled "Preferences," provides that a bankruptcy trustee or a debtor-in-possession may "avoid any transfer of an interest of the debtor in property" if such transfer was made:

1. to or for the benefit of a creditor
2. for an account of an antecedent debt owed by the debtor before such transfer was made
3. while the debtor was insolvent
4. on or within 90 days before the date of filing of the petition or between 90 days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider
5. enabling such creditor to receive more than such creditor would receive if:
  - (a) the case was a case under chapter 7 of this title (liquidation)
  - (b) the transfer had not been made
  - (c) such creditor received payment of such debt to the extent provided by the provisions of this title.

The debtor or the trustee will bear the burden of proof that all of the above-stated conditions have been met. The debtor will not have to prove that element of insolvency unless you indicate that you believe the debtor was not insolvent during the 90-day period.

## Your rights: summary of defenses

Section 547 of the Bankruptcy Code provides a number of defenses to prevent you from having to return the payments you were entitled to receive. The defenses frequently asserted by suppliers of goods and providers of services in preference actions are as follows.

■ **Contemporaneous exchange of new value (contemporaneous-exchange defense)**

■ **Payments in the ordinary course of business (ordinary course-of-business defense)**

■ **Providing new value after the transfer (subsequent new-value defense) and**

■ **If the aggregate value of the property that constitutes or is affected by the transfer is less than \$5,000 (available to the bankruptcy cases filed on or after Oct. 17, 2005 only)**

**Contemporaneous-exchange defense:** You must prove that the parties intended and knew that the transaction was a contemporaneous exchange for new value (e.g. new shipment, benefit to the debtor's estate). COD transfers and wire transfers (if payments applied to new shipments) fall into this category. The exchanges must occur almost simultaneously.

**Ordinary course-of-business defense:** You must prove that the payments the debtor made to you during the 90-day period before its bankruptcy filing were made in accordance with the ordinary business terms between you and the debtor and were also consistent with the ordinary business terms in the industry in which both you and the debtor were/are players. If there is not much history of dealings between you and the debtor, some courts would focus their inquiries more on the contractual arrangements and/or the industry standards.

However, the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 has made this defense more available to you. In the bankruptcy cases filed on or after Oct. 17, 2005, you would only have to prove *either* the payments the debtor made to you during

the 90-day period before its bankruptcy filing were made in accordance with the ordinary business terms between you and the debtor *or* these payments were made in accordance with the ordinary course of business terms in your industry.

**Subsequent new-value defense:** This defense allows you to recover or offset value to the extent of new value given after a preferential transfer was made. This new value must have been given for an otherwise unavoidable transfer. You can use this defense when a payment is applied to an old debt, but, in exchange, you just ship new goods or render additional services to the debtor. It is not necessary that the invoices for the subsequently shipped goods or newly extended services remain unpaid.

**Transfers aggregating less than \$5,000:** This new defense is available only in the bankruptcy cases filed after the general effective date of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, last Oct. 17. If the payments you received during the 90-day period before the debtor's bankruptcy filing total less than \$5,000, the debtor or the trustee cannot recover these payments from you.

## Preventive tips

If you know that the financially distressed company with which you are doing business may be filing for bankruptcy relief imminently, you can minimize your exposure in any potential preference ac-

tions by doing the following.

■ **Switching to COD transfers in order to create availability of the contemporaneous-exchange defense**

■ **Shipping additional goods or providing services simultaneously with payments by wire transfers in order to create further availability of the contemporaneous-exchange defense**

■ **Applying recently received payments to the outstanding invoices for which the payments are recently due according to the contract terms or normal terms of dealing between the parties — instead of the oldest outstanding invoices — in order to maximize the strength of your ordinary course-of-business defense**

■ **Depositing the checks from the debtor immediately in order to minimize any delay in debtor's payments when you invoke the ordinary course-of-business defense; the determinative date here is the date the check is cleared, not the date of receipt**

■ **Contacting your bankruptcy counsel even if the preference actions are pending in a distant district. In this electronic age, your bankruptcy counsel should be able to defend you in these preference actions from your hometown.** □

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