



Bankruptcy Law Alert

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This Bankruptcy Law Alert is intended to provide general information for clients or interested individuals and should not be relied upon as legal advice. Please consult an attorney for specific advice regarding your particular situation.

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The Debtor Owes Me Money *AND* Is Suing Me ... Is This Right?

One of your customers owes you money but is in financial trouble. The customer promises to pay you next week or next month or after a big receivable comes in. When you finally get paid, you find out that your customer has filed for protection under the Bankruptcy Code within 90 days of paying you. "At least I got paid," you think. That is, until about a year later, when you receive a demand to return that payment because it was a preferential transfer. "How can this be right?" you wonder. "I just got paid what I was owed."

This scenario is becoming more and more common. Unfortunately, so are claims in solicitation letters or other advertising from lawyers or other paraprofessionals promising that preference liability can be brought down to zero. Yes, it's possible that preference liability can be extinguished by statutory defenses, but only after a thorough and comprehensive review of the facts, the transaction and payment history, and the law of the federal judicial circuit where the bankruptcy case was filed. This alert is intended to provide you with some knowledge about preferential transfers and how to apply the defenses.

A. How can a "normal" payment be called a preferential transfer?

By federal statute, a debtor can avoid any transfer that meets the statutory criteria. The debtor need only prove that the transfer was made to or for the benefit of a creditor, the transfer was made on account of an antecedent debt made while the debtor was insolvent, the transfer was made within 90 days prior to the bankruptcy filing date (or one year if an insider is involved), and the transfer enabled the recipient to receive more than he would have received if the transfer had not been made and the debtor were liquidated.

B. What are the defenses to preferential transfers?

There are three defenses outlined in the Bankruptcy Code:

1. Substantially Contemporaneous Exchange for New Value

This defense can be used if a creditor can prove that the creditor extended new value to the debtor, the creditor and the debtor intended this exchange to be contemporaneous, and the exchange was in fact contemporaneous. The parties must have intended the exchange to be contemporaneous. An example of substantially contemporaneous exchange for new value is a COD or cash in

advance payment for goods during the 90 days immediately preceding the debtor's bankruptcy filing.

2. New Value

Another defense is for new value extended to the debtor that was not a contemporaneous exchange. New value means money or money's worth in goods, services, or new credit given. Transfers are protected only to the extent of the amount of the new value. In order for the new value defense to apply, three events must occur in a specific order:

- i. The creditor must have received a transfer that is otherwise avoidable as a preference under the Bankruptcy Code;
- ii. After receiving the preferential transfer, the preferred creditor must have advanced additional credit to the debtor on an unsecured basis; and
- iii. That additional credit advance must be unpaid to some extent as of the bankruptcy filing.

3. Ordinary Course of Business

There is also an ordinary course of business defense. This is a popular defense to claim, but it can be the hardest of the three defenses to prove. A creditor can establish this defense by demonstrating that the transfer was in payment of a debt incurred by the debtor in the ordinary course of business of the debtor and the creditor and that the transfer was either (i) in the ordinary course of business between the debtor and the creditor; **or** (ii) made according to the ordinary business terms — ordinary terms based on industry standards. In order to prove these elements, often an expert is required to provide analysis of what is ordinary in the various scenarios.

CONCLUSION

If you receive a preference demand, it is very likely that a lawyer who is well-versed in bankruptcy can settle the preference claim without the need of protracted litigation or a trial. It is important that an experienced professional help you examine the elements of the transfer to determine if it fits the definition of a preferential transfer and help you complete a thorough analysis of all your possible defenses to negotiate the best result for you.