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Bankruptcy Preference Claim Can Be An Unwelcome Surprise

By: Bill Gray. *This was posted Monday, June 11th, 2012*

One of the most difficult conversations a bankruptcy attorney can have with a client is to explain the concept of bankruptcy "**preference** claims". The conversation often arises when a client suddenly receives a letter (or worse yet, a lawsuit) in which someone is demanding that the client give back a payment it received several years ago from a company that subsequently filed bankruptcy. "How can that be!?" they ask. "They paid me for goods or services we provided to them, and they owed us the payments!" "Why do I have to give them the money back?"

Well, the difficult answer is that in certain circumstances the **Bankruptcy Code** does require that some payments the **debtor** made before filing bankruptcy have to be returned to the debtor. It sounds crazy, but the reason or public policy for this law is to ensure that all similarly situated creditors receive equal treatment when a bankruptcy is filed. Without such a law, a debtor could, prior to filing bankruptcy, "prefer" certain creditors by paying certain debts, yet not paying others. In the resulting bankruptcy case, the creditors who got paid are much better off than those who did not get paid. To prevent this disparity, **Congress** included in the Bankruptcy Code the law about preference payments. 11 U.S.C § 547.

Fortunately, there are several circumstances in which you do not have to return payments received prior to a bankruptcy filing. The Bankruptcy Code has a very specific and detailed definition of what a "preference payment" is. The Bankruptcy Code defines a preference as:

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 (pre-existing) debt;
4. made within 90 days of the bankruptcy filing (or within 1-year if the transfer was to an insider);
5. made while the debtor was insolvent; and
6. which allows the creditor to receive more than it would have received if the payment had not been made, and the claim was paid through the bankruptcy process.

Although the definition is intentionally broad, if any of these elements are missing, the payment received is not a preference payment, and thus does not have to be returned. Because of the public policy behind this law, there is no requirement of "intent" for any of the elements. But, each element must proven by a preponderance of the evidence, although there is a presumption of insolvency in the 90 days before the bankruptcy filing.

Even if the particular payment or payments fall within the statutory definition of preference, the Bankruptcy Code offers certain defenses, or circumstances in which the payment nevertheless does not have to be returned. The three most common defenses are: 1) ordinary course; 2) subsequent new value; and 3) contemporaneous exchange for new value.

In future posts, we'll examine the particulars of these defenses so you can be prepared if someone wanting a return of payment reaches out to your company. If you are party to such a claim, you should get the advice of a **Virginia creditors' rights lawyer** who can explain your rights.