A change in the bankruptcy preference law

Will you have to give money back? **Interviewed by Jason Lloyd**

Companies can be forced to return payments they receive within 90 days of their customer's bankruptcy, but recent amendments to the Bankruptcy Code will make it somewhat easier for them to retain those so-called "preferential" payments.

"A preference or preferential transfer is any transfer of property (including money) made by an entity to a creditor of that entity within 90 days prior to the entity's filing for bankruptcy," says Roger Stevenson, a commercial litigation attorney with Roetzel & Andress. "A bankruptcy trustee, or a Debtor in Possession, has the power to 'avoid' such a transfer and recover the property transferred. The property recovered (less the trustee's fees and legal expenses) is then shared with all of the entity's creditors."

Smart Business spoke to Stevenson about preference avoidance actions and how companies can defend themselves.

Roger Stevenson
Partner, Bankruptcy & Creditors' Rights Group
Roetzel & Andress LPA

You get paid within 90 days of your customer's bankruptcy and you have to give the money back?

Not necessarily. Some transfers are protected from avoidance by 'affirmative defenses' set forth in the Bankruptcy Code. Affirmative means that the defendant will have the burden of proof. For example, a transferee might escape preference liability if he can establish that he delivered the goods and received the money at essentially the same time. This is called the contemporaneous exchange defense. And a transferee might escape or reduce preference liability to the extent he can establish that, after receiving a payment from the debtor-transferor, he gave new value (usually in the form of goods and services) to the debtor-transferor for which he did not receive payment. This is called the subsequent new value defense.

Are there other defenses?

Another is the ordinary course of business defense. For many years, transferees who asserted this defense had the burden of proving: (1) that the subject transfer was made and received in the ordinary course of business of both the transferor and the transferee, and (2) that the transfer was made according to ordinary business terms.

The first prong would require testimony from company representatives about the way the two parties had historically conducted business with each other. The transferee would attempt to prove that the subject transfer was consistent with past practice between the two parties.

The second prong would require testimony from expert witnesses about the way other businesses in the same industry generally conduct business. The transferee would attempt to prove that the subject transfer was consistent with the way most businesses in that industry would have done things.

The defense did not work unless you could prove both prongs?

Let's say a buyer paid a seller 120 days after he received the goods. If the buyer filed bankruptcy within 90 days after the payment was made, the bankruptcy trustee would likely file suit against the seller for the amount of the payment. The seller might be able to produce a long history showing that the buyer had always taken 120 days to pay an invoice. But the seller might be forced to admit that none of its other customers took that long to pay. And the seller might not be able to find an expert who would say that it was ordinary in the seller's and the buyer's industries for a customer to take 120 days to pay. The seller would have proven the first prong, but not the second, and his ordinary course of business defense would have failed.

It works the other way around, too. It wasn't enough to prove that you did it the way everybody always did it if you had never done it that way before. Let's say the payment was made within 90 days before bankruptcy and just 30 days after goods were shipped. The seller should be able to establish that the payment was made according to ordinary business terms. But what if the seller had to admit that, over a long history of transactions with the buyer, this was the only payment that had been made in less than 120 days? The seller would have proven the second prong, but not the first, and his ordinary course of business defense would have failed.

How has the law been changed?

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, most often noted for making it more difficult for an individual debtor to receive a discharge in a Chapter 7 bankruptcy case, also makes it easier for a company to establish an ordinary course of business defense in a preference avoidance action. The change was a simple one. The 'and' between the first and second prongs was changed to an 'or.' So in bankruptcy cases filed after Oct. 17, 2005, a preference defendant need only prove that the subject transfer was consistent with the past practice between it and the debtor, or that the subject transfer was consistent with general business practice.

ROGER STEVENSON is a commercial litigation attorney with Roetzel & Andress LPA. He can be reached at (330) 849-6619 or rstevenson@ralaw.com.

Insights Legal Affairs is brought to you by Roetzel & Andress LPA

© 2006 Smart Business Network Inc. Reprinted from the June 2006 issue of *Smart Business Akron/Canton.*