Summer 2021: Time to Act to Protect Distressed Accounts Receivable from Bankruptcy Preference Liability

Related Professionals

Lisa P. Sumner
919.573.7423
lsumner@nexsenpruet.com

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Bankruptcy preference claims are viewed by businesses as an unfair legal tool that debtors and trustees use to take money back, even though the pre-bankruptcy payments from the debtor were for legitimate business debts. By planning in advance, creditors can mitigate the risk of having to disgorge funds received from a debtor in the 90-day "preference period" leading to a bankruptcy filing. The key is to take protective steps far enough in advance of your customer's bankruptcy filing. Ideally, creditors need to act well before the preference period starts, which requires speculation and luck because most debtors don't announce their decision to file for bankruptcy in advance. However, if you believe, as many people do, that a rise in bankruptcy filings is on the horizon, then implementing some of the following strategies now could help insulate you from the risk of loss on preference claims.

Switch to Payment in Advance or True Cash on Delivery

In order to recover a payment as a preferential transfer, the debtor or bankruptcy trustee must prove the payment was for an "antecedent" or pre-existing debt. By definition, a prepayment cannot be a preference. Similarly, there is no preference liability if the debtor pays for a product or service on the same day that the debtor receives it. Beware though, payments must be truly contemporaneous. Ordinary checks can bounce and even automated clearing house (ACH) drafts can fail if not backed by sufficient deposits, in which case the failed payment doesn't protect the creditor from preference liability. This is a situation where cash (or a cash equivalent like a confirmed wire transfer) is king.

Implement Regularly Recurring Automatic Payments

To establish the “ordinary course of business” defense to preference claims, a creditor must prove either that the payment was received in the ordinary course of business between the parties or on terms ordinary for their particular industry. The defense focuses on the length of delay between a sale and payment of the corresponding invoice, comparing the delay during the 90-day preference period with the delay during the parties’ prior billing history or delay common in the applicable industry. For example, if the debtor routinely paid invoices about 64 days late during the 90-day preference period, but also paid invoices about 64 days late during the period 91 days to 2 years before the preference period, then the preference period payments were made in the ordinary course of business between the parties.

With the exception of deferred rent payments which were granted special Congressional protection from preference liability under the Consolidated Appropriations Act of 2021, the slowing of payments that began in the second quarter of 2020 as COVID pandemic shutdowns took effect are likely to make it hard for many creditors to prove that there has been anything ordinary about the timing of collections over the last year. However, if a creditor can get a customer (who is a prospective debtor) to implement a new practice of recurring monthly ACH payments, they can start building a new payment history that, over time, could form the basis of a successful ordinary course of business defense. If the customer files for bankruptcy within 90 days of changing the method of payment, that change itself can defeat the defense, but the hope is that a bankruptcy filing is far enough down the road that a ‘new normal’ has been established by then.

Take a Lien on Collateral with Equity

Fully secured creditors aren’t preference targets because the debtor cannot make the required showing that by getting the preference period payment, the creditor received more money than the creditor would have received if the payment had not been made and the debtor liquidated its assets in a chapter 7 bankruptcy case. In other words, if the creditor would have been paid in full anyway, then the payment cannot be recovered as a preference. So if your customer has valuable assets that aren’t encumbered by prior liens and is willing to grant you a security interest in those assets as a means of recourse in the event of nonpayment, take a lien. But do it right and do it soon. Consult an attorney to be sure your lien gets perfected in accordance with applicable law because unperfected liens are worthless in bankruptcy, and hope your lien gets perfected before the 90-day preference period begins so the lien itself isn’t challenged as a preferential transfer. If the value of the collateral is less than the amount of your claim (i.e., your lien is undersecured), the lien will provide only limited protection from preference liability, but you’ll be grateful for every defense you have when the time comes.

Get a Guarantee

Having an affiliated business or individual business owner liable on a guarantee of your customer’s debt may not protect you from facing a preference claim in your customer’s bankruptcy case if the customer, not the guarantor, was the party making payments to you during the 90-day preference period. But if a creditor has to disgorge payments received from the debtor as a preference, the creditor may be able to rely on a guarantee to recover such losses. Alternatively, if the debtor filed for bankruptcy leaving a large unpaid receivables balance and is unlikely to pay unsecured creditors, a guarantee may be the only viable means of collection. Although there are complexities to using

guarantees in the bankruptcy context that are beyond the scope of this article (e.g., is the guarantor's waiver of reimbursement rights against the debtor valid in your jurisdiction; could payment by the guarantor be challenged as a fraudulent transfer), having more than one potential source of recovery is a welcome hedge.

Conclusion

Preference claims inevitably come when bankruptcy filings rise, but preference liability can be minimized through advance planning. Contact a member of our creditors' rights team at Nexsen Pruet today to get started.