

SCOTT AND GOLDMAN

ATLANTA OFFICE • 590 W. Crossville Rd. Ste. 104 • Roswell, GA 30076 • 770-993-1220 • Fax# 770-993-2220

WHAT IS A PREFERENCE?

Occasionally, a creditor will receive a demand on behalf of a bankruptcy estate (from either a trustee, debtor in possession or their attorney, but generally the trustee) to refund to the bankruptcy estate payments the creditor received from its customer which is now in bankruptcy.

A layman's definition of a preference or preferential payment is any payment (whether cash or property, made by the debtor to an unsecured creditor on a past due account within 90 days prior to the debtor filing bankruptcy.

The receipt of a preferential payment is not illegal. A debtor has a right to pay whichever creditor it may choose at whatever time it chooses. However, one of the primary objectives of the Bankruptcy Code is to ensure that all creditors of a class are treated alike. One of the ways that the Bankruptcy Code accomplishes this objective is to give the bankruptcy trustee the power to recover from the creditor those payments that meet the statutory definition of a preference. If after the trustee's demand, the creditor does not voluntarily return the payments, the trustee can file suit to obtain a judgment against the creditor for the amount of the alleged preferential payments.

A creditor who is faced with a demand to return preferential payments should be aware that the trustee must prove a preference as defined in the Bankruptcy Code. Even if there was a preferential payment, the creditor may have a defense. The most common defense a creditor may assert is that the payment was received as a "contemporaneous exchange for new value" (such as payment for additional merchandise) or that the payment was received in the "ordinary course of business" (such as payment received according to the terms of sale, accepted industry practice, or debtor's previously accepted payment history).

Because of the complexity of the law and the need to consider the facts peculiar to each case, the determination of whether a payment was a preference is never as clear-cut as a trustee or the trustee's attorney would have the creditor believe.

How To Respond To A Preference Claim

A creditor who receives a demand to return a

preferential payment has a number of alternatives which range from disregarding the demand to acquiescing and returning the money. How to respond requires some thought. The following offers guidance in choosing among the alternatives.

First, the creditor should determine if a payment was received from the debtor. If a payment was received, the creditor should decide if the amount of the claim is large enough to warrant spending money to defend against the trustee's demand. If so, then the creditor should seek professional advice to help him decide if the payment was a preference and whether the creditor has any defenses to the claim.

Whether a creditor intends to hire an attorney or deal directly with the trustee, all of the pertinent records should be assembled, such as copies of the invoices reflecting the terms of sale and records establishing when the payment or payments were received. The business records should be reviewed to determine the debtor's payment history, that is were the payments timely or chronically delinquent. The creditor should determine the customary time period for payment within the creditor's particular industry. All of this information is relevant to the creditor's defenses. Having it available will assist the decision maker (whether attorney or creditor) in dealing intelligently with the trustee.

Is disregarding the trustee's demand ever warranted? The answer has to be "Yes, sometimes".

If the amount at issue is small (under 1,000.) and the creditor is in a different district than where the bankruptcy case is pending, then it is unlikely that a trustee would file suit because the economics of litigation would not warrant his doing so. Obviously, as the amount of the trustee's demand increases or the creditor is in the same district as the bankruptcy case, the response would change. In that event, the creditor most likely should not disregard the trustee's demand but rather discuss settlement.

Is there ever a case when the creditor should acquiesce and return the money to the trustee based solely on his demand? The answer to that question is virtually "Never". Only under those rare circumstances when it is crystal clear

that the payment was a preference and the creditor has no defense what so ever should the creditor even consider the outright refund of the payment.

If the creditor does not return the payment, the trustee's only option is to file suit. In order to avoid filing suit a trustee will usually accept a compromise amount. Many factors enter into the settlement equation. Besides the amount of the demand and location of the bankruptcy court, the most important consideration would be the merits of the trustee's case and the creditor's defense. If it is no asset case, the trustee's financial ability to litigate is also a consideration. In negotiating settlement with a trustee, all of these factors must be considered. The more favorable they are to the creditor the lower the settlement offer should be. The creditor should not hesitate to offer 50-60 percent, keeping in mind that the final settlement may be higher.

Sometimes the preference received by the creditor was collected by an attorney or collection agency employed on a contingent fee basis. Generally, the trustee will demand that the creditor return the entire preferential payment even though the attorney or collection agency received a percentage of the claim as their fee. The creditor should be aware that the fact that the attorney or collection agency received a percentage of the claim does not diminish the creditor's liability to the trustee to return the entire preference payment. The attorney or the collection agency rightfully earned their fee when they collected the claim. A creditor faced with this situation might be well-advised to consult with the attorney or collection agency that assisted in collecting the claim before negotiating with the trustee.

If a creditor returns a preferential payment to a trustee, the creditor has 30 days to file a proof of claim in the debtor's bankruptcy proceeding for the amount returned to the trustee. If the creditor already filed a proof of claim, then the proof of claim can be amended by adding the amount returned to the trustee.

Negotiations are they key to resolving disputes regarding preferential payments. Because of the complexity of the bankruptcy laws, where economically practical, a creditor should seek the advice of an attorney.