

Small Business Defenses Against Bankruptcy Trustee

“Preference Actions”

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It's natural to be furious when you receive a bankruptcy trustee's demand letter-----or even worse, suit papers demanding that you cough up every payment you received in the 90 days prior to your customer's bankruptcy filing. However, once you calm down, you will need to get serious as to what defenses you may have against this outrageous “preference action” against you. Be forewarned that it may involve some intense number crunching, but this painful exercise may actually break in your favor.

It's a fact of commercial life that some creditors routinely get paid faster than others. The usual reason is simple timing of incoming bills and outgoing checks, while others get paid ahead of the norm because they're the squeaky wheels who aggressively demand payment. But once a bankruptcy case is filed, the trustee in bankruptcy has the power under the bankruptcy code to recover payments made in the 90 days immediately prior to the bankruptcy filing that resulted in some unsecured creditors getting more than others. The aim is to treat all unsecured creditors the same. In theory that sounds admirable – at least until you realize that you are being asked to give up what you received so that others may share pro rata in those payments.

The dismay you feel can be multiplied if the customer who's slipped into bankruptcy is a long term customer who may have been slow to pay, but eventually always sent a check. You may have nursed him along in hopes that he'd get back on his feet. Maybe you loathe cutting off any customer, even the slow paying ones. Or maybe you weren't as attentive as you might have been in monitoring this account receivable, partially because it wasn't a gigantic sum. After all, who in this never-ending recession hasn't needed a little help? It seemed perfectly reasonable until you were asked to pay back all payments received during the 90 days before he filed his bankruptcy petition-----and then the number was frighteningly huge.

You call your lawyer, crying foul. Your lawyer tells you that it's standard practice for the bankruptcy trustee to look at the debtor's check book (you called him your customer; now he's a “debtor in bankruptcy”!)

and to write a demand letter to every payee of every check written by the debtor during the “preference period,” that is within the 90 days prior to the bankruptcy filing.

Your lawyer also tells you that if you don’t return any such payments or otherwise formally try to compromise the sum, the trustee can subpoena you to depositions, maybe to a mandatory mediation, and to court hearings wherever in the United States the bankruptcy case was filed since he has the power of nationwide service of process. You see the travel costs mounting just to defend; and your lawyer tells you that you will need to engage local counsel in that distant state. Your temperature continues to rise as you see that the trustee has got you over a barrel.

You want to go after the trustee personally. You naturally vent to your lawyer. This is just a blankity-blank shakedown, you say; and he calmly agrees.

Why is the trustee making you out to be the bad-actor? You certainly never engaged in any knee-cracking collection efforts to gain an unfair advantage over other creditors. You were helping by just doing business with the debtor when others would not. You were just trying to scratch out a living yourself. This isn’t fair, you say. Isn’t this preference action against your business un-constitutional? Didn’t the liberal, borrower-cuddling Congress go too far? Isn’t it continuing to cause all kinds of hell for struggling small businesses like yours? (Or so you think until your lawyer advises you that Congress is expressly authorized by the Constitution to make laws regarding bankruptcy. Coming back to reality, you admit you don’t want to fund a major Constitutional law challenge, no matter how emotionally compelling the idea might be. So what are you to do? It offends you to cave to this unjust pressure from the scurrilous bankruptcy trustee. But what are your defenses? Actually, there are two statutory defenses that just might get you off the hook entirely or at least reduce your exposure. They are embedded in Section 547 of the Bankruptcy Code.

The first is called the “ordinary course of business” defense under 11 U.S.C. Section 547(c)(2). The Code actually does realize that every vendor and each customer develops a “course of business” between them over time. On the payment side, it’s measured by how much time elapses between the invoice date and the payment date. Let’s say that the customer, over the period from one year before the bankruptcy filing and up until 90 days

before the bankruptcy filing (outside the preference period), made five payments to the vendor for goods or services and that the average number of days elapsed between invoice and payment for those five payments was 129 days. Now compare that average aging number against the actual days elapsed between each invoice date and its payment to determine if payments you received during the preference period were permissible within the terms of the Bankruptcy Code.

For example, let's say that the average payment cycle for your unfortunate customer was 129 days in the year-long period before the preference period began. Further, assume three payments were made to you during the preference period and that those payments were made 101, 120, and 132 days after the date of the invoices in question. Each payment very likely will be deemed to have been made in the established "ordinary course of business," since each payment was close to the average 129 days. You can then persuasively argue that the payments you received are not subject to a preference attack and therefore should be free of any requirement to disgorge the funds to the bankruptcy trustee. You win.

Of course, the facts can also cut the other way. If the aging for the three payments would come to 65 days for the first payment, 120 days for the second and 180 days for the third, the trustee would evaluate each on its own merits. The 65-day payment may be deemed to be "preferential," particularly if you pursued aggressive collection measures to persuade the customer to pay on an accelerated basis. In that event, you lose and will have to re-pay that sum to the trustee. The second may be deemed to be within the ordinary aging process and held not to be preferential; on that one, you win and wouldn't have to restore the payment to the trustee. The 180-day payment, interestingly, may be deemed to be so outside the 129-day average as to be preferential, in which case you lose again, and again have to repay the money to the trustee.

Sometimes, the averages get distorted because your customer has put off paying his smaller payables – eg, \$35 – until he is paying a larger payable. Maybe he figures you don't care. As a result, it just lingers on the books until he makes another larger payment to you. However, when it comes time to compute the average aging of your accounts receivable, this miniscule amount totally skews the average. Call it an "outlier", toss it out of your calculations, and watch your average improve. Courts understand this and often agree that the outliers should not be counted in the preference

calculations. Other times, the math isn't as clear, since there are partial payments or payments credited against the oldest outstanding bill. That may require more explanation, but the "ordinary course of business" defense may still exist.

If the "ordinary course of business" defense is not available – because the computations don't cut in your favor – you may still have a second line of defense. It's called the "subsequent new value" defense and is found in 11 USC (c)(4). This defense is based on your *not* having cut off the customer when he was becoming more distressed in his lead-up to the bankruptcy filing. Or perhaps you did business with him during the 90-day preference period without even being aware that he was in financial straits.

Let's say that after receiving a payment during the 90-day preference period you shipped the customer \$52,000 in new goods or provided services to him in that amount, for which you took no collateral. Let's assume the customer sent you several partial payments during the same 90-day period, totaling \$32,000. You may be able to set off the total amount you're owed against any apparently "preferential" payments you received. As a general rule, just compute the total of all your invoices during the preference period and subtract the total of payments received during the preference period. If the total of goods and services (\$52,000) rendered exceeds the amount of the payments (\$32,000) received during the preference period, then you can defeat the trustee's claim for re-payment.

In short, every vendor needs to monitor his receivables closely, especially during times of economic turbulence. Don't casually allow small sums to get forgotten by the customer; insist on payment so that the average of aging invoices does not have wild swings. Take collateral if you have reason to suspect that your customer is in financial distress and, if the collateral is unavailable, stop doing business with him. If you do get hit with a preference demand by a bankruptcy trustee, calmly run your numbers. Never pay the full face value of the trustee's initial demand. Remember that you may well have valid defenses that at least will give you room to negotiate a settlement with the trustee----or even to win the case at trial, if the matter rises to that level.