

PREFERENCE CLAIMS IN BANKRUPTCY

It is bad enough receiving a notice from the bankruptcy court indicating that someone who owes you money has filed a bankruptcy petition. To make matters even worse, electrical contractors sometimes receive a letter from the bankruptcy trustee, a few weeks later, demanding repayment of amounts previously paid by the debtor.

The Bankruptcy Code permits the trustee (or in some cases the debtor itself) to recover payments made to a creditor within the 90-day period preceding the filing of the bankruptcy petition. The policy behind this rule is to remedy a situation where the debtor “prefers” certain creditors by making payments to them just before filing for bankruptcy, and to diminish the advantages that a creditor might gain by pursuing aggressive collection actions on the eve of the bankruptcy filing. If “preferential” payments are made within the 90-day period, the creditor can be forced by the bankruptcy court to “repay” those payments to the trustee or the debtor in possession.

What is the preference? Section 547 of the Bankruptcy Code defines a preference as:

1. A payment on an antecedent (as opposed to a current) debt;
2. Made while the debtor was insolvent;
3. Made to the creditor within 90 days of the filing of the bankruptcy petition;
4. That allows the creditor to receive more on its claim than it would have otherwise received through the bankruptcy proceeding.

For “insiders” who have a special relationship with the debtor, the preference period is one year (as opposed to 90 days for non-insider creditors).

An electrical contractor who receives a letter demanding repayment of a payment received prior to the bankruptcy filing should not automatically jump to the conclusion that the payment was a “preference” which will have to be repaid.

For example, payments to a fully secured creditor (such as a creditor who holds a

mortgage or a construction lien) normally aren't considered preferences.

Likewise, a "contemporaneous exchange for new value given" is not a preference. A payment which is made at the same time the product or service is provided is an example of a "contemporaneous exchange."

Payments made "in the ordinary course of business" are not preferences. Whether a payment is "in the ordinary course of business" depends on how soon the payment was made after the product or service was provided, the past practices followed between the debtor and the creditor, and the practices followed in the industry. Whether a payment was made in the "ordinary course of business" has been the subject of much litigation in bankruptcy courts around the country.

Another defense to a preference claim may exist if the creditor extended additional credit to the debtor after the payment was received.

There are a number of other possible defenses. Not every payment which is received within the 90-day period will have to be repaid.

An electrical contractor who receives a preference demand letter should consult with an attorney to determine whether defenses to the preference claim are available. Normally, a prompt response should be made to the person who sent the letter demanding repayment, setting forth any defenses to the preference claim which may exist. A prompt, well-written response which raises appropriate defenses will in many cases cause the trustee or attorney for the debtor to drop the matter and refrain from filing suit in the bankruptcy court to force repayment of the alleged preference payment.