All's Fair in Love and Bankruptcy

Aylix K. Jensen
612-877-5434 | Aylix.Jensen@lawmoss.com
LawMoss.com/people-aylix-k-jensen

Aylix is a member of our Financial Services team. She defends marketplace lenders, collection agencies, creditors, and other businesses in consumer litigation.

Sarah E. Doerr
612-877-5297 | Sarah.Doerr@lawmoss.com
LawMoss.com/people-sarah-e-doerr

Sarah practices in Financial Services and Litigation, focusing on creditors' remedies and creditor-side bankruptcy issues.

Consider the following scenario: You are a creditor who lends $100,000 to a debtor on an unsecured basis. Ten years later, the debtor repays the $100,000 loan to you. Shortly thereafter, the debtor files for bankruptcy. You subsequently receive a letter from the debtor's bankruptcy estate demanding the return of the $100,000 payment, which was made by the debtor within 90 days preceding the debtor's bankruptcy petition date. The letter threatens litigation unless a resolution is reached.

The Bankruptcy Code refers to these pre-bankruptcy payments as "preferential transfers." While it may seem patently unfair, absent a defense, a bankruptcy trustee can recover or "claw back" these payments for the benefit of the bankruptcy estate while you, the creditor, are left holding the proverbial bag.

What is a Preferential Transfer?

Preferential transfers are defined in Section 547 of the Bankruptcy Code. Section 547(b) allows a bankruptcy trustee to "unwind" certain transactions that take place in the 90 days preceding a debtor's bankruptcy filing, the "preference period." The principle underlying the statute is that individual creditors should not receive more than their fair, *pro rata*, share of a debtor's limited assets when a debtor is approaching bankruptcy. A preference claim allows a bankruptcy trustee to unwind certain transfers of assets a debtor made shortly before the debtor files for bankruptcy and recover those assets for the eventual distribution to *all* creditors.

The rationale for preference avoidance is twofold. First, the Bankruptcy Code seeks to promote equality between similarly situated creditors (e.g., secured creditors, unsecured creditors, bondholders, etc.). Second, the trustee's ability to claw back assets transferred in the months leading up to a bankruptcy disincentivizes creditors from trying to convince a struggling entity to pay it ahead of other creditors.

What is a Savvy Creditor to Do?

Under Section 60(b) of the Bankruptcy Act of 1898, preference recovery required that a creditor receive a transfer with "reasonable cause to believe that the debtor is insolvent." This changed with the enactment of the Bankruptcy Reform Act of 1978. Under today's Bankruptcy Code, if a creditor receives a payment that fits the statutory definition of a preferential payment, the bankruptcy trustee may recover the payment, irrespective of whether the creditor acted with suspicious intent.

This strict liability framework is, in practice, much more nuanced. The Bankruptcy Code provides for a number of defenses that a creditor may invoke to prevent the trustee from clawing back payments made during the preference period. Among the most commonly used is the "ordinary course of business" defense, which prevents a trustee from recovering otherwise preferential payments if the creditor can show the debtor's timing and pattern of payment did not change from the pre-petition *status quo*.

Creditors also often invoke the defense that the transaction was for goods or services immediately received (rather than pursuant to an extension of credit), sometimes termed a "contemporaneous exchange for new value." A creditor may assert a similar defense where the creditor provided the debtor with "subsequent new value" for which it was never paid.

"All's Fair in Love and Bankruptcy" Continued on Page 9

A Preference Demand Is Rarely Cause for Panic

Bankruptcy trustees typically make demands to all recipients of transfers within the 90-day lookback period without considering whether a defense to preference liability exists. Should you receive a demand or a complaint filed in Bankruptcy Court for return of an allegedly preferential payment, please reach out to Moss & Barnett. Our bankruptcy attorneys can quickly determine whether the payments in question are indeed preference payments and which of the statutory defenses are best suited to the facts at hand. These demands and lawsuits can nearly always be settled prior to prolonged litigation.