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You can't be serious. The bankruptcy code requires me to repay what?

Tired of what he viewed as a series of injustices based on bad calls in one match, the immortal John McEnroe once screamed at the chair umpire, "You can't be serious. You cannot be serious."

This is the exact response I often receive from clients upon learning that they can be sued to return money which they received from an insolvent corporation in the three months prior to a bankruptcy filing.

These are clients who believe that they have been "stiffed" as a result of non-payment from the then-faltering (and now bankrupt) entity.

These are clients that oftentimes knew the company was faltering and wanted to help it out by continuing to do business with it. But then they find out they had to spend more money to pay me to navigate the bankruptcy process, fight for and establish their claim and estimate an expected recovery from the bankruptcy case.

Just as the sting from that entire process has begun to wear off, they receive a letter from a trustee demanding the return of additional monies. As you can imagine, these letters are about as well received by creditors as that call was to McEnroe.

As large Chapter 11 cases begin to wind down and are converted to Chapter 7 cases, the debtor or trustee often begins to investigate payments made by the debtor in the three months prior to its filing for bankruptcy.

These payments are commonly called preferences and pursuant to the Bankruptcy Code are avoidable and recoverable by the bankrupt entity's estate.

As a bankruptcy attorney who represents both trustees and creditors in this equation from time to time, I understand (and agree with) the financial policy underlying the preference recovery process.

The provisions of the Bankruptcy Code attempt to ensure that similarly situated creditors receive similar distributions. The preference process requires both unsecured creditors to return any money received and share equally in the resulting distribution.

Unfortunately, the preference avoidance provisions of the Bankruptcy Code are blunt and do not, on their face, account for the nuances of business relationships in these types of situations.

With certain exceptions, almost any payment made by the debtor in the 90 days before filing for bankruptcy is automatically deemed preferential (the time period is one year for insiders of the debtor).

There is no intent required. In larger cases, thousands of individuals and entities get swept up in the preference avoidance and recovery process, and the dollars seeking to be returned balloon into the tens of millions.

However, in their infinite wisdom, the drafters of the Bankruptcy Code did provide preference recipients with several statutory defenses to preference demands. Specifically, Section 547(c) lays out a number of instances in which a trustee may not avoid an otherwise avoidable, preferential transfer.

The three most common of those defenses are known as the ordinary course defense, the new value defense and the contemporaneous exchange defense.

Mountains of case law have been built around each of these defenses, and there is no way to cover all of the fine points in the space of this column, but hopefully the descriptions that follow provide some insight and guidance.

The contemporaneous exchange defense is found at Section 547(c)(1) of the Bankruptcy Code and provides that a trustee may not avoid a transfer otherwise avoidable under Section 547(b) if that transfer was 1) intended to be a contemporaneous exchange for new value and 2) in fact a contemporaneous exchange.

DECODING THE CODE

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In other words, if you hand the faltering company a widget in one hand while it pays you for it with the other hand that transfer is not avoidable under the preference recovery scheme pursuant to the contemporaneous exchange defense.

The new value defense is found at Section 547(c)(4) of the Bankruptcy Code and provides that a trustee may not avoid a transfer otherwise avoidable under Section 547(b) if, after that transfer, the creditor gave new value to the debtor which basically went unpaid.

The concept here is that if the faltering company pays you for one widget on Day 1 and you provide 10 widgets to the faltering company on Day 10 and the faltering company files for bankruptcy on Day 30 without having paid you for the 10 widgets, the payment you received on Day 1 is not avoidable pursuant to the new value defense.

The ordinary course defense is found at Section 547(c)(2) of the Bankruptcy Code and provides that a trustee may not avoid a transfer otherwise avoidable under Section 547(b) if that transfer was made 1) in the ordinary course of business between the parties or 2) according to ordinary business terms in the respective industry.

So, if the invoice for your widget says "Net 30" and for the past two years the faltering company has always paid you on the 30th day and in the 90 days before bankruptcy the faltering company continues to pay you on the 30th day after invoice, those payments are probably not avoidable pursuant to the ordinary course of business defense.

The avoidance and recovery of preferential transfers is one of the least understood and most universally hated (at least from the creditors' point of view) components of the bankruptcy process.

However, there are a number of statutory defenses that can reduce and, in some instances, eliminate any liability for receipt of preferential transfers.

Retaining counsel experienced in bankruptcy matters is always important, but applying the intricacies of the above mentioned defenses, in addition to attacks on the very definition of what is or is not a preferential transfer to begin with, are matters properly handled by attorneys familiar with this area of law.

However, armed with an understanding of the policy reasons behind the preference statute and a general knowledge of the most common defenses, creditors should be able to evaluate the strengths and weaknesses of their preference cases and make an informed choice on their next steps.