The Bankruptcies Are Coming – What Should I Be Doing To Avoid Preference Exposure?

By: Jeff Hendricks on April 27, 2020 on graydon.law

The policies implemented to address the COVID-19 will have far reaching economic consequences. While federal and state governments are doing what they can to ease the short term impact, the fact remains that businesses of all sizes are addressing crises caused by a lack of consumption and a disruption of most all of the other factors that keep an economy afloat.

The reality is that a number of these businesses will not be able to survive this crisis which will, no doubt, create an uptick in bankruptcy filings. Indeed, one of the provisions of the CARES Act recently enacted to address the COVID-19 crisis was to expand access to the streamlined Chapter 11 bankruptcy process to more businesses by increasing the debt limits from 2.7 million to 7.5 million for a one-year period. With more bankruptcies on the horizon, the prospect of your business having to address claims for preferential payments arising out of these bankruptcies likewise increases.

For the uninitiated (and be grateful if that includes your business), a preference is a claim under the bankruptcy code where the debtor or appointed trustee can demand that a business return all payments made by the debtor during the ninety days that preceded the bankruptcy filing, *even if the company still owes you money!* What follows are a few steps your business can take to put your business in the best position to deal with this eventuality.

1) **The Golden Rule – always take the money!** It is better to have the money and worry about a payment that may be argued as a preference in the future than not have the money at all. Always take the money.

2) **Be Consistent.** One of the available defenses to a preference claim is that a payment was made in the ordinary course of business. There is more nuance to this phrase than one would think. For purposes of this summary, it is best understood that a business should be consistent with its customer from a collection standpoint. If terms are net 30, but no demand is made until 60 days have elapsed, maintain that practice. If payments are always made by check, don't demand a wire. If a customer generally pays around 75 days from

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invoice, it is critical to hold that line, as the applicability of the ordinary course defense is ultimately judged against the payment history prior to the preference period. A deviation from the pre-preference average, in either direction, undermines the defense. The bottom line is that credit policies regarding collection efforts should be implemented and consistently enforced.

3) **Keep And Maintain Good Records.** Preference claims are generally made several years after the transactions at issue. They are generally pursued near the two-year anniversary of the filing of the bankruptcy. Proving the available defenses requires accurate, demonstrable records that establish dates of invoices and shipments, dates that payments were received and communication logs with the customer showing the attempts (or lack thereof) to collect the debts at issue. Therefore, it is important that a business has access to these records many years after the relevant transactions and that they capture the information noted.

4) **Cash on Delivery (COD).** Sales made on COD terms are not recoverable as a preference. Preference liability is aimed at the creditor that tightens the vice on credit as a business descends into financial distress. While COD would seem to fit that bill, the policy makers included a safe harbor for such transactions to ensure that a business retains access to goods/services on non-credit terms. Therefore, COD can be implemented regardless of the proximity of the customer to an eventual bankruptcy without fear of preference exposure.

While hope that the reader will not find his/her business on the receiving end of a preference demand, implementing these tips will put your business in the best position to address such a claim if it does arise.

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