

Top 10 Tips to Minimize Preferential Transfer Exposure

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A preference claim occurs when you are sued for all monies you received from a debtor in the 90 days before its bankruptcy filing. Fortunately, you can proactively protect yourself from these actions. Here are 10 top tips to do so.

1. Keep a Close Eye on the Debtor. Always maintain open lines of communication. Request current financial statements. Obtain third-party credit reviews of the company. Monitor news regarding the debtor. Listen to what others are saying about the company. Knowing the debtor's financial condition can help you cautiously and proactively take steps to minimize both your short-term credit risk and longer-term preference exposure.

2. Be Consistent. A common defense to a preferential transfer claim is the ordinary course of business defense, which asks whether the transfers during the 90-day period before bankruptcy (the "preference period") were in the ordinary course of business. The ordinary course defense has two prongs: subjective (discussed in this section) and objective (discussed in the next section). Only one of the two prongs needs to be met to establish the ordinary course defense.

Under the subjective prong, the payments during the preference period are compared to the payments received during the pre-preference period to see if they significantly deviate. This defense is maximized when payments during the preference period are in line (i.e., "ordinary") when compared to pre-preference period transactions. The key to maximizing the ordinary course defense is consistency. Seek to maintain the appearance that existing payments are ordinary as compared to prior payments. One easy way to do this is to identify the average days-sales-outstanding for the last 12 months and seek to keep current payments within an acceptable range of that average. Avoid changing terms or practices that have existed for long periods. If collection efforts must be made, attempt to do so gently and verbally, without a written record that will be subject to discovery.

3. Keep Payment Terms in Line With Industry Standards. The objective prong of the ordinary course defense asks whether the payments you received during the 90 days before bankruptcy were normal for your industry. To qualify for this defense, the payments need to be within a range of reasonableness for your trade. For example, if the average days-sales-outstanding is 30 days but payments ranging from 20 to 40 days are also ordinary, anything between 20 and 40 days would be acceptable. But if the timing of the payments significantly deviates from the industry norm, that should be a red flag that the objective ordinary course defense will not work.

4. Watch Your Receivables. Keep your receivables current and promptly take appropriate corrective action. Develop and consistently apply uniform policies for reminding customers of late receivables and seeking payment. Ask yourself: "Is this debtor treated any differently than other similarly situated debtors with whom we deal?" If the answer is "yes," that should be a warning that your ordinary course defense may be in jeopardy. If additional pressure is needed, first communicate orally rather than in email. Be judicious in how you record internal notes detailing your collection efforts.

5. Maintain Your Credit Limit. An increased risk factor for a preferential transfer is letting the debtor exceed its credit limit. If the limit has been passed, you will be in the difficult position of trying to recover the excess credit amount from a debtor that is struggling financially. Such a scenario increases the likelihood that your collection efforts may cause any payments to be unordinary. Firmly maintaining your credit limit is simply a good procedure for helping prevent increased preference exposure.

6. Shorten Your Payment Terms. Shortening payment terms can significantly reduce preference exposure if you are doing a large volume of business with the debtor. The majority of jurisdictions recognize what is commonly known as "paid new value." This means that if you provide goods or services to the debtor during the preference period, you can use the value of those goods or services as an off-set or reduction of any preferential transfer that occurred before the goods or services were provided, even if those same goods or services are later paid for by the debtor during the preference period. If you have longer payment terms (i.e., net 60 days), you will have relatively little new value. In contrast, if you have shorter payment terms (i.e., net 15 or 20 days), you will have greater new value for the preference period. Shortening payment terms may also help ease credit limit exposure.

7. Wisely Use Your Leverage (If You Have It). Are you a critical supplier to the debtor? Does the debtor rely on you in some unique way? How adversely would the termination of your business relationship affect the debtor? Not all creditors are created equally. If you are a critical vendor, gently use your leverage to encourage the creditor to meet its payment terms. How you use that leverage will significantly color a judge's determination of whether the actions were appropriate. For example, you can often achieve the same result by being firm in a gentle and diplomatic manner versus being hostile and threatening.

8. Minimize the Red Flags. Bankruptcy trustees frequently try to defeat the ordinary course defense by arguing that preference period payments were different because of the red flags that accompanied them. These red flags include (but are not limited to): reducing the debtor's credit limit, shortening payment terms, changing the mode of payment for just the debtor (such as requiring payment via wire transfer rather than check), holding shipments until the debtor has paid for certain outstanding invoices, and putting undue collection pressure on the debtor. Obviously, these actions are common-sense steps that a credit manager may need to take to reduce short-term credit exposure. But unfortunately, they also bring with them longer-term risk of adversely affecting the ordinary course defense. If these actions must be taken, try to do so in as delicate a manner as possible. A good way to minimize red flags is to establish consistent credit policies for all your customers and ensure that they are regularly applied across the board. These credit policies should include standards for establishing, reviewing and adjusting credit limits and credit terms; protocols for seeking recovery of past due invoices; and rules for determining when to stop shipments and/or switching to cash-on-delivery or cash-in-advance terms. Implementing and consistently applying uniform credit policies for your customers is akin to eating right and regularly exercising: It requires upfront personal discipline, but the long-term benefits are well worth it.

9. Require Cash on Delivery. The contemporaneous exchange defense to preferential transfers requires that the parties intend to make a contemporaneous exchange of value and that the transfer itself is, in reality, also substantially contemporaneous. If you are contemplating such a transaction, make sure that it is well documented (a clear email confirming both parties intend this will be sufficient). Then take steps to ensure that the exchange of cash for product or services happens at least within a few days of each other, although the same day or next day is much better.

10. Put the Debtor on Cash-in-Advance Terms. This is the best and easiest way to avoid a preferential transfer. By its own terms, a cash-in-advance payment is not a preferential transfer because the debtor is not making payment for an antecedent debt. If you are selling product to the debtor on open terms (without any pre-existing contract), you have the luxury of going to cash-in-advance when the circumstances warrant it.

What Should You Do If You Are Sued? Implementing and following the policies and processes outlined above can help protect you during the inevitable storm that will arise if a debtor/customer later files for bankruptcy. If you do receive a demand for return of an alleged preferential transfer or, worse, are sued, consult with counsel to discuss your defenses and how the dispute may be most cost-effectively resolved.

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