DEFENDING PREFERENCE ACTIONS IN BANKRUPTCY

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Recently one of our trade association clients learned that bankruptcies can be painful for creditors, sometime even years after the debtor files for bankruptcy. Our client only discovered that a judgment in excess of $86,000 had been entered against it as a result of a preference action (a suit by a debtor or its trustee seeking to recover payments made in the 90 days before the bankruptcy was filed) when the assets in its bank account were frozen. Unlike in an ordinary lawsuit, service of a complaint in a preference action in bankruptcy can be accomplished through regular mail delivery. The client, however, failed to receive the complaint. As a result, it only discovered that suit had been brought after a default judgment had been entered and the assets in its account were frozen (for twice the amount of the judgment ($172,000)). Fortunately, we were able to negotiate a resolution based upon defenses available to our client on the underlying preference action, but it nonetheless highlights the risks posed by a trade association customer or member's bankruptcy. While you cannot prevent a member or customer from reorganization or liquidating, there are important steps that you can take to minimize your risk of suffering significant financial losses.

One obvious concern associated with a member or customer's bankruptcy is its failure to pay its bills. Even more problematic, as noted above, are attempts by a debtor or its bankruptcy trustee to recover payments made to your trade association during the "preference period." This article illustrates some steps that you can take to minimize or eliminate those risks.

The simplest way to avoid becoming a creditor in a bankruptcy action is not to provide goods or services to a customer without having been paid in advance. This may not always be practical but more and more trade associations are opting to take this route. By doing so, there will be no outstanding claims in the event of a member's or customer's bankruptcy filing.

If payment is made before providing the goods or services at issue, no creditor relationship exists and the payments are not on account of a pre-existing debt. Under the Bankruptcy Code, a debtor normally may only avoid payments made on account of an antecedent (pre-existing) debt.

Recently we have confronted numerous preference actions brought against trade associations for annual membership dues paid in the 90 days prior to the member's bankruptcy filing. If the annual dues are paid before the year in question, we defend against such actions on the grounds that the payment made was not pursuant to an antecedent debt. This defense ordinarily is very effective – although it is not foolproof in instances where the debtor ceases

taking advantage of the membership during the course of the year due to liquidation. Under those circumstances, the debtor may argue that it received less than a reasonably equivalent value in exchange for the payment and will thus seek to recover a portion of the annual dues.

Examples may be helpful in illustrating how effective certain defenses are based upon different fact patterns.

* Member A makes its $20,000 annual membership payment in December of 2009 for its 2010 membership. Member A files for bankruptcy reorganization in January of 2010 and continues to operate throughout the entire year.

A compelling case can be made that the payment was not pursuant to an antecedent debt and, moreover, that the creditor provided "new value" in terms of the future services provided in exchange for the payment made. None of the payment made should be subject to recovery as a preference.

* Member B makes its $20,000 annual membership payment in December of 2009 for its 2010 membership. Member B files for bankruptcy reorganization in January of 2010 but liquidates in June of 2010.

The payment was not made pursuant to an antecedent debt but the trustee will argue that the debtor received less than a reasonably equivalent value in exchange for the payment. The trustee may be successful in recovering $10,000, representing the services for the half of a year during which the member did not enjoy the benefits of its membership.

* Member C makes its $20,000 annual membership payment in March of 2010 for its 2010 membership. Member C files for bankruptcy reorganization in June of 2010 and continues to operate throughout the year.

The trustee will argue that the payment was made pursuant to a pre-existing debt and thus is subject to recovery as a preference. The creditor should argue that, at a minimum, it provided new value in exchange for the payment for the time period from March to December of 2010 and thus $15,000 of the membership fees are immune from recovery.

As reflected above, the ability to defend against preference actions is fact-dependent and largely driven by the creditor's ability to ensure that payments from members and customers are made prior to providing goods or services. There are numerous other defenses that may be asserted against preference actions, including the "ordinary course of business" defense, and the "contemporaneous exchange for new value" defense, which are not addressed here. This article, however, highlights some of the critical steps that can be taken to limit exposure and maximize recovery. If you are interested, GKG Law attorneys will conduct a no-cost initial consultation to discuss these planning alternatives. Please feel free to contact Brendan Collins by telephone at 202.342.6793 or by email at bcollins@gkglaw.com.