Avoiding a bankruptcy clawback: shield your business payments

A business owner learns that one of her customers has filed for bankruptcy. She rushes to check her books and breathes a sigh of relief after seeing that the customer paid all of their outstanding invoices just days before going bankrupt. Unbeknownst to the business owner, those payments may have to be paid back to the bankruptcy estate as a clawback.

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One of the principal policies underlying bankruptcy law is fairness to creditors, which attempts to ensure that similarly situated creditors are treated equally. To promote this goal, creditors in a bankruptcy are placed into classes, with members of each class sharing proportionally in distributions of a bankrupt debtor's assets.

This policy can be hampered when a debtor pays a preferred creditor immediately before a bankruptcy, to the detriment of other creditors. To ensure that a debtor's limited money does not disappear to creditors favored by the debtor, the Bankruptcy Code allows a bankruptcy trustee to claw back such payments.

A payment is considered a preference if it meets five criteria: It is made to a creditor; for a debt owed prior to the payment being made; while the debtor was insolvent; during either 90 days before the bankruptcy filing for ordinary creditors or one year for insiders of the debtor; which allowed the creditor to receive more than it would have received in distributions from the bankruptcy estate.

If a payment is a preference, it must be paid back to the trustee unless a valid defense can be established.

Several defenses are available to creditors, including for substantially contemporaneous exchanges. Typically, point-of-sale transactions and those that involve cash on delivery will meet this defense. Another common defense exists for payments made in the ordinary course of business, which analyzes the typical transactions between the parties and in the relevant industry. If it is common for a debtor to pay invoices within 60 days of delivery, for example, those payments may meet the ordinary course defense.

Businesses can take steps to shield payments received from financially troubled customers from being subject to bankruptcy clawback or preference liability. The most effective means is to require prepayment, COD, or point-of-sale transactions only. Businesses can also strategically apply payments to invoices in a manner designed to fit within preference defenses.

To recover a preference, the bankruptcy trustee must commence a lawsuit within the bankruptcy case, typically preceded by a demand letter. Any business that receives such a letter should consult with bankruptcy counsel to determine whether they have valid defenses to the claim. Consulting with a bankruptcy attorney is also advisable prior to entering into sizable business transactions with a financially troubled company to attempt to eliminate preference risk. Doing so can help reduce the risk that a business gets embroiled in a bankruptcy, and worse, has to repay money that it was owed due to bankruptcy clawback.

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