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Proactive Steps to Protect Your Company Against Preference Claims

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With the difficult economic events in recent weeks, companies should be proactive to protect themselves in the event their customers become insolvent and are forced to file for bankruptcy protection. One of the biggest dangers of customer bankruptcies – and something that often catches creditor companies by surprise – is the risk of preference claims.

What are preference claims?

Preference claims are a creature of the bankruptcy code. They enable a debtor that has filed for bankruptcy to “claw back” many of the payments it made to creditors during the 90 days prior to its bankruptcy petition. Preference claims can be surprising to creditors because they arise from payments made before the customer filed for bankruptcy – often when creditors had no knowledge that the customer was insolvent.

How can my company protect itself against preference claims?

The best way for companies to protect themselves against preference claims in this difficult economic environment is to understand the available defenses to preference claims and conform their business practices to maximize the potential for a successful defense. The following are two strategies that have been successful in past cases:

1. Maintain the Ordinary Course.

One of the most commonly asserted defenses to preference claims is the “ordinary course of business” defense. That defense is available when the payment at issue was made in the ordinary course of business between the customer and creditor or in accordance with ordinary business terms. This means that if no unusual circumstances accompanied the payment – such as a change in credit terms or unusual pressure from the creditor – the payment likely would not be subject to a preference claim.

Thus, if a creditor suspects that its customer is sliding toward bankruptcy, it should be mindful of the risk of preference claims before it changes credit terms or pressures the customer to make a payment. This is not to say that there is anything wrong with making legitimate extra efforts to collect an account – there isn't at all – but creditors should be aware that they might end up having to pay back some of those collections if preference claims are filed.

2. Switch to Cash-Before-Delivery.

Another strategy for avoiding preference claims is to switch to cash-before-delivery transactions. With cash-before-delivery transactions, goods are paid for before they are shipped. Thus no debt is created in the transaction, and no payments are made on account of pre-existing debt. Without pre-existing debt, there can be no preference claim.

Marshall Winn (mwinn@wyche.com; 864-242-8204) and David Koysza (dkoysza@wyche.com; 864-242-8384) would be glad to discuss these and other proactive strategies with companies at any time.

This memorandum is provided by Wyche for educational and informational purposes only and is not intended and should not be construed as legal advice. We will be pleased to discuss with you in more detail the application of any of the topics covered above to your circumstances. Please contact either of the above attorneys or your other contact within our firm for more information.