



BEWARE THE CLAW-BACKS

A CUSTOMER'S BANKRUPTCY CAN BURN YOU TWICE

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In the annals of business disappointments, a few stand out as shockingly unfair and costly. This is one of those painful two-fer's: Bankruptcy claw-backs of preferential payments.

Here's how it works: You steadfastly provide your goods or services to a corporate customer. Your customer's business is slow. It's having trouble paying you. But you're loyal, so you give it additional time. Finally, it pays you a good chunk of what it owes, but a short time later it files for bankruptcy. You mourn the loss of a customer, lick your wounds because you weren't paid in full and move on or so you think.

A year or two later, you get a demand from the trustee supervising your old customer's bankruptcy. The trustee wants you to return that partial payment for which you so patiently waited. Incredulous, you call your attorney. "This has to be a mistake," you implore. "I was owed the money and more, I finally got a partial payment. How could I possibly have to give it back?"

This has to be a mistake, right? You get to keep the money, right?

Wrong.

THE 'PREFERENTIAL' TREATMENT

One of the goals of bankruptcy law is to make sure that creditors of a bankrupt business are treated fairly and equally. First, secured creditors get to keep the collateral that they got from the debtor. This is only fair. These creditors bargained for certain collateral when they lent money to the debtor. When the debtor doesn't pay, the creditor is entitled to keep the collateral to satisfy the debt.

Next, creditors who have no collateral or other security the "unsecured" creditors are supposed to be treated equally. If there is any money left after the secured creditors are paid, each unsecured creditor gets a share of the debtor's remaining assets. The person in charge of the bankruptcy, usually a trustee, totals up the amounts owed to unsecured creditors, as well as the remaining assets, and then pays each unsecured creditor a percentage of the amount it was owed. For example, if the debtor has \$100,000 in leftover assets and a total of \$1 million in unsecured debt, then there is enough money left to pay 10 percent of the unsecured debt. A creditor owed \$200,000 will get \$20,000.

And you're not allowed to sidestep this slicing of the remaining pie. If you get money out of turn, or "preferentially," you must give it back. First, the law requires examination of all payments that you

received during the 90 days before the debtor entered bankruptcy. This 90-day period is extended to one year if you are an “insider,” such as an owner or officer of the bankrupt business.

Then, if any of these payments are a “preference,” you have to return them. Generally, a preference is any payment you received for an old debt. Whether a debt is old depends on when your customer normally pays you or what payment terms are customary in your industry. There are no hard and fast rules. Often any money owed for more than 30 days is considered old debt and treated as a preference.

For example, say you normally get paid 15 to 30 days after you send out your bills. Your customer fails to pay you on time. Finally, it catches up after three months. This payment could be a preference. Keep your fingers crossed that your customer doesn’t enter bankruptcy within 90 days after you got that payment otherwise you’re facing a claw-back.

AVOIDING THE CLAW

What can you do to minimize the risk of a claw-back? Here are a few pointers:

- **Know your customer’s financial situation.** And act on it. Is your customer on the brink of bankruptcy? If so, try to get payment in advance or insist on payment on delivery.
- **Train your collection team.** They need to understand that allowing customers to delay payment exposes your business to the risk of losing some or all of what you collect.
- **Keep good records.** You may not have received a preference, but that does not mean you won’t have to fend off claw-back claims. Preserve all of the records relating to payments received from customers that have gone bankrupt, including your customer contracts, invoices and payment history. Keep it all for at least 36 months after the bankruptcy filing.
- **You may have a defense to repaying the money.** For example, if you provided the debtor with additional goods or services after you received a preferential payment, under bankruptcy law you added “new value” and may have a defense to repaying some or all of the claw-back.

These situations are sad. A valued customer went out of business. We didn’t get paid all we were owed. Then we had to repay what we did get. Only one thing makes it worse: we might have avoided all of this if we followed a few rules.

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