



Avoid the Clutches of the Bankruptcy Preference Claim!

By G. Marshall Kent Jr.

Imagine your firm has just completed an extensive, high risk construction project. Your firm just received payment from your customer in exchange for your “waiver of lien claims upon final payment” that you signed and submitted last week. You pay subcontractors and suppliers after receiving your retainage, and shortly thereafter learn that the customer just filed for bankruptcy protection.

The significance of that proceeding will become abundantly clear if you receive a demand letter from the customer’s lawyer or bankruptcy trustee demanding, pursuant to 11 U.S.C. §547, that your firm return the retainage it was paid, plus any other monies paid

to your firm by the debtor during the 90-day period preceding the debtor’s bankruptcy filing. Such a letter may well send a chill up your spine, particularly if the amount of money in issue could result in the bankruptcy of your own business!

Do not write a check to the debtor or the trustee just yet. Upon receiving notice of a preference claim, consult with a lawyer that understands the nature of your construction business, and is experienced in defending bankruptcy preference claims. Defenses may well exist that would negate a preference claim. At the very least, such defenses may substantially reduce the amount of an alleged preference claim.

What exactly is a preference claim? A preference arises when a creditor (the contractor) receives a payment from a debtor (the customer) during the 90-day period (one year in the case of a party defined as an “insider”) prior to the debtor’s bankruptcy filing, during which period the debtor is presumed to be insolvent. In essence, this means the contractor received more monies than it possibly would have through the bankruptcy disposition, resulting in preferential treatment in relation to other similarly situated creditors. As a result, this payment, deemed a preference payment, must be returned and distributed evenly among all of the debtor’s creditors.

Fortunately, the presumption is rebuttable and may result in the creditor retaining the payment. Contractors may be

able to use applicable state lien law to defeat the presumption that a preference has occurred. A contractor who carefully monitors and preserves its lien rights should receive payment at a time when the contractor can still file and enforce a lien. In certain states (including Georgia), an argument can be asserted that the customer (the debtor) paid the contractor with funds subject to a “constructive trust” for the benefit of the contractor and its subcontractors and suppliers. In view of the contractor’s lien rights, the contractor may assert that this payment was not preferential since the funds did not belong to the debtor, but rather, the debtor was holding the funds in trust to pay the contractor. Also, the contractor may assert that, because of the lien rights, it would have been paid in full in the bankruptcy case, and, therefore, it did not receive a preference from the debtor.

Other defenses are also available to the contractor that negates a preference claim. Delivery of a lien waiver (an agreement by the contractor to forbear in asserting a materialman’s lien) to a debtor concurrently with a contractor’s receipt of payment may give the contractor a “contemporaneous exchange for new value” defense to a preference claim. Alternatively, the contractor may be able to establish that payments received from a customer were made in the ordinary course of business, pursuant to ordinary business terms. Thus, if the contractor can show that the payment was made in accordance with the established customs or previous business relationship with the debtor, then such payment may be insulated from recovery under the ordinary course of dealing defense. The delivery of subsequent new value (including work or materials supplied on credit) to a debtor after a prior payment by the debtor also may mitigate or extinguish a preference claim. One or all of these defenses may protect a contractor. Accordingly, every effort should be made by the contractor to investigate defenses to a preference claim and avoid adverse financial consequences due to a customer’s bankruptcy.

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