BE CAREFUL HOW YOU APPLY PAYMENTS FROM A FINANCIALLY TROUBLED CUSTOMER - OR YOU MAY HAVE TO RETURN THEM

by Elizabeth Graham Weber

The situation is becoming increasingly prevalent in today's economy: a financially troubled customer is behind on payments to your company. The customer finally makes a payment on his account and then, within 90 days, files for bankruptcy protection. Generally, this payment is deemed a preference, a payment made on a past-due account by one who within 90 days of making the payment files bankruptcy. Even though your company may have already cashed the check and applied it to the customer's account, the trustee in the bankruptcy case may sue your company for return of the preferential payment to the debtor's bankruptcy estate.

The purpose of the preference statute is to promote the equal treatment of all of a debtor's creditors and to avoid the rush by creditors to the courthouse, which may in fact precipitate a bankruptcy filing. Consequently, if a creditor is paid immediately before a debtor files a bankruptcy petition, generally the payments must be returned to the trustee, who in turn divides the monies on a pro-rata basis between all creditors.

The Bankruptcy Code does include a number of exceptions to the general preference statute, including exceptions for "contemporaneous exchanges" and payments made in the "ordinary course of business."

If the payment from the debtor was received by the creditor at the same time the goods or services were provided by the creditor to the debtor, then the transaction may be considered a contemporaneous exchange and the creditor may keep the payment. Likewise, if the payment occurs in the "ordinary course of business" between the debtor and the creditor and according to ordinary business terms generally, then too the creditor may keep the payment.

Because of this, when dealing with a financial strapped customer who makes a payment on a delinquent account, your company should consider applying that payment to the most recent invoice versus the oldest. This is because a payment applied to the newest invoice may actually fall within your ordinary business terms, for example net 30 days. To the extent it does, you will have a valid defense to a preference action brought by a trustee in bankruptcy. If a customer tells you he will be making a payment on his account, instruct the customer to put the newest invoice number on the check to further support a claim that both parties intended the payment to be applied to the newest invoice. Rather than paying you a lump sum to be divided between numerous invoices, instruct your customer to cut several checks in the exact amounts of the individual newest invoices and working backwards.

While there may be exceptions to those times when you are best advised to apply payments from troubled customers to the newest invoice, this is an issue you should be addressing with each payment received from a troubled customer.