

Avoidance Issues:

Why I Came Around on Preferences

Brook E. Gotberg

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Now

Then





11 U.S.C. §
547 –
Preferential
Transfers

(b) [T]he trustee may, based on reasonable due diligence in the circumstances of the case and taking into account a party's known or reasonable knowable affirmative defenses . . . [,] avoid any transfer of an interest of the debtor in property –

- (1) to or for the benefit of a creditor;
- (2) for or on account of an antecedent debt owed by the debtor before such transfer was made;
- (3) made while the debtor was insolvent;
- (4) made on or within 90 days before the [petition was filed]; and
- (5) that enables such creditor to receive more than [under a chapter 7 distribution if the transfer had not been made[.]

Hypothetical Preferential Transfer

- Debtor, Trivanta Corp., hired Ironmark Construction to do some work on the company's main building.
- Ironmark sent its invoice, which Trivanta paid 30 days late.
- Trivanta filed for bankruptcy within 90 days after the payment.



Where are Preferential Transfers Avoidable?

- ✓ Individual chapter 7
- ✓ Municipal chapter 9
- ✓ Individual chapter 11
- ✓ Farmers and Fisherman chapter 12
- ✓ Corporate chapter 7
- ✓ Corporate chapter 11
- ✓ Small business chapter 11
- ✓ Wage earner chapter 13



Preference Actions Settle

Part 2: List Certain Transfers Made Before Filing for Bankruptcy

1. Certain payments or transfers to creditors within 90 days before filing this case

List payments or transfers—including expense reimbursements—to any creditor, other than regular employee compensation, within 90 days before filing this case unless the aggregate value of all property transferred to that creditor is less than \$8,575. (This amount may be adjusted on 4/01/28 and every 3 years after that with respect to cases filed on or after the date of adjustment.)

☐ None

Creditor's name and address	Dates	Total amount or value	Reasons for payment or transfer Check all that apply
3.1. Creditor's name _____ Street _____ City _____ State _____ ZIP Code _____	_____ _____ _____	\$ _____	<input type="checkbox"/> Secured debt <input type="checkbox"/> Unsecured loan repayments <input type="checkbox"/> Suppliers or vendors <input type="checkbox"/> Services <input type="checkbox"/> Other _____
3.2. Creditor's name _____ Street _____ City _____ State _____ ZIP Code _____	_____ _____ _____	\$ _____	<input type="checkbox"/> Secured debt <input type="checkbox"/> Unsecured loan repayments <input type="checkbox"/> Suppliers or vendors <input type="checkbox"/> Services <input type="checkbox"/> Other _____

4. Payments or other transfers of property made within 1 year before filing this case that benefited any insider

List payments or transfers, including expense reimbursements, made within 1 year before filing this case on debts owed to an insider or guaranteed or cosigned by an insider unless the aggregate value of all property transferred to or for the benefit of the insider is less than \$8,575. (This amount may be adjusted on 4/01/28 and every 3 years after that with respect to cases filed on or after the date of adjustment.) Do not include any payments listed in line 3. Insiders include officers, directors, and anyone in control of a corporate debtor and their relatives; general partners of a partnership debtor and their relatives; affiliates of the debtor and insiders of such affiliates; and any managing agent of the debtor. 11 U.S.C. § 101(31).

☐ None

Insider's name and address	Dates	Total amount or value	Reasons for payment or transfer
4.1. Insider's name _____ Street _____ City _____ State _____ ZIP Code _____ Relationship to debtor _____	_____ _____ _____	\$ _____	_____
4.2. Insider's name _____ Street _____ City _____ State _____ ZIP Code _____ Relationship to debtor _____	_____ _____ _____	\$ _____	_____

Conflicting Preferences in Business
Bankruptcy: The Need for Different Rules
in Different Chapters

Brook E. Gotberg*

ABSTRACT: *The law of preferential transfers permits the trustee of a bankruptcy estate to avoid transfers made by the debtor to a creditor on account of a prior debt in the 90 days leading up to the bankruptcy proceeding. The standard for avoiding these preferential transfers is one of strict liability, on the rationale that preference actions exist to ensure that all general creditors of the bankruptcy estate recover the same proportional amount, regardless of the debtor's intent to favor any one creditor or the creditor's intent to be so favored. But preference law also permits certain exceptions to strict preference liability and gives the estate trustee discretion in pursuing preference actions. This undermines the policy of equal distribution by permitting some creditors to fare better than others in the bankruptcy distribution. However, these practices are arguably necessary to promote the conflicting bankruptcy policies that seek to maximize the estate for the benefit of creditors and also encourage the survival of struggling businesses.*

As a result, the law of preferences is internally inconsistent and controversial, attempting unsuccessfully to serve multiple policy masters simultaneously. Much of the analysis on preferences up to now has proposed amending preference law generally in an attempt to satisfy these often conflicting demands. This Article recommends a more dramatic approach: returning preference law to a mechanism of equal distribution in liquidation proceedings by eliminating true exceptions to the rule, and dealing over with preference law in the

RELATIONAL PREFERENCES
IN CHAPTER 11 PROCEEDINGS

BROOK E. GOTBERG*

It is no secret that creditors hate so-called "preference" actions, which permit a debtor to recover payments made to creditors on the eve of bankruptcy for the benefit of the estate. Nominally, preference actions are intended to equalize the extent to which each unsecured creditor must bear the loss of a bankruptcy discharge, or to discourage creditors from rushing to collect from the debtor in such a way that will push an insolvent debtor into bankruptcy. But empirical evidence strongly suggests that, at least in chapter 11 reorganization proceedings, preference actions do not fulfill either of these stated goals. Interviews with debtors, trade creditors, and attorneys involved in small- and medium-sized chapter 11 bankruptcy cases establish both that creditors are not deterred from collecting by preference actions, and that preference actions are not applied equally in a system where debtors are able to choose which preferential transfers to avoid and how much to accept in settlement of preference actions. Instead, these interviews suggest an alternative justification for preference law in chapter 11, one more consistent with promoting a debtor's ability to exercise strategic leverage over its creditors in an effort to reorganize. In this way, the law of preference avoidance is actually one of preference perpetuation, and is exercised with an eye towards preserving valuable relationships within bankruptcy proceedings.

Introduction

In most bankruptcy proceedings, creditors correctly anticipate that the debtor will prove unable to repay all its debts in full, requiring unsecured creditors to write off most, if not all, of what they are owed. In common

PREFERENCES ARE PUBLIC RIGHTS

BROOK GOTBERG*

In the wake of the Supreme Court's decision in *Stern v. Marshall*, there is widespread uncertainty as to what other proceedings may constitutionally fall within a bankruptcy court's core jurisdiction. Supreme Court jurisprudence has been cryptic regarding the constitutional limitations of non-Article III courts, but the Court has identified a "public rights exception" to the general rule that the judicial power must be exercised only by judges with life tenure and salary protection. This public rights exception has not yet been explicitly extended to a bankruptcy proceeding, but the reasoning of the Court strongly suggests that a trustee's motion to avoid preferences would fall under the public rights exception, as a proceeding stemming exclusively from bankruptcy law and necessary to resolve claims against the estate. Accordingly, and contrary to what most scholars have suggested, preference proceedings fit comfortably within the jurisdiction of bankruptcy courts, even after the Supreme Court's ruling in *Stern*.

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POKING AT PREFERENCE ACTIONS: SBRA AMENDMENTS SIGNAL
THE NEED FOR CHANGE

BROOK E. GOTBERG

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Optimal Deterrence and the Preference Gap

Brook Gotberg*

It is generally understood that the way to discourage particular behavior in individuals is to punish that behavior, on the theory that rational individuals seek to avoid punishment. Laws aimed at deterring behavior operate on the assumption that increasing the likelihood of punishment, the severity of punishment, or both, will decrease the behavior. The success of these laws is evaluated by how much the targeted behavior decreases. The law of preferential transfers—which punishes creditors who have been paid prior to a bankruptcy filing at the expense of other, unpaid creditors—has been defended on the grounds that it deters a race to collect from a struggling debtor. However, deterrence theory suggests that the low likelihood of punishment and the cap on punishment associated with preference law make it a very poor deterrence. Further, empirical evidence drawn from interviews with affected creditors, debtors, and attorneys demonstrates that in practice preference law does little or nothing to deter targeted behavior and, in the process, imposes significant costs. The weaknesses of preference law call for its significant revision, to place a greater focus on specific categories of creditors to be punished on account of their pre-bankruptcy activities.

Legislative History – 1978 Bankruptcy Code

First, by permitting the trustee to avoid prebankruptcy transfers that occur within a short period before bankruptcy, *creditors are discouraged from racing to the courthouse to dismember the debtor* during his slide into bankruptcy. The protection thus afforded the debtor often enables him to *work his way out of a difficult financial situation through cooperation* with all of his creditors.

Second, *and the more important*, the preference provisions facilitate the prime bankruptcy policy of *equality of distribution among creditors of the debtor*.

First Camp: Equality is the Reason for Preference Law

- The baseline standard for unsecured creditors is a pro rata distribution in chapter 7. Preference law ensures that standard is complied with and not “cheated” in the days just prior to bankruptcy.
- The standard of equality is what creditors would likely have negotiated beforehand under a “Creditor’s Bargain.”
- Even Steven is fair and square.



What Do the Creditors Say?



First Camp: Equality is the Reason for Preference Law

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- The standard of equality is what creditors would likely have negotiated beforehand under a “Creditor’s Bargain.”
- Even Steven is fair and square.
- Equality is a predictable and consistent standard.



But if Equality is the Reason . . .

- Why stop at 90 days?
- Why limit it to transfers made while the debtor was insolvent?
- Why do we have any of the exceptions to liability?

Exceptions to Preference Liability

- (1) Substantially contemporaneous exchange;
- (2) Ordinary course transfer;**
- (3) Purchase money security interest;
- (4) Followed by new value;
- (5) Floating lien on inventory and accounts;
- (6) Statutory lien;
- (7) Domestic support obligation;
- (8) *De minimus* payments of less than \$600 (consumer) or \$7,575 (commercial)

Legislative History – 1978 Bankruptcy Code

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Second, *and the more important*, the preference provisions facilitate the prime bankruptcy policy of *equality of distribution among creditors of the debtor*.

Second Camp: Deterrence is the Reason for Preference Law



- There may be innocent transfers, and the law should allow those to stay in place under a theory of repose or commercial finality.
- There may be essential trade partners with whom the debtor must maintain good relationships – we want to encourage their continued engagement with the debtor.

But if Deterrence is the Reason . . .

- Why is the law written so broadly?
- Why is the law written so narrowly?
- Why does the law apply in liquidation proceedings?
- How is the creditor supposed to know when it is or is not okay to force collection?

What About
Both?



The Math of Deterrence



Benefit of Taking the Action



Cost of Taking the Action

~~Don't Do It!~~
Go For It!

Rational Decision

The Math of Deterrence



Benefit of Taking the Action



Cost of Taking the Action

Go For It!

Rational Decision



BFF

Perpetuated Preferences

“the trustee *may* . . . avoid
any transfer”

Perpetuated Preferences





Critical Vendor

Perpetuated Preferences

“the trustee *may* . . . avoid
any transfer”

Making Preferences (Equal) Again

✓ Individual chapter 7

✗ Municipal chapter 9

✗ Individual chapter 11

✗ Farmers and Fisherman
chapter 12

✓ Corporate chapter 7

✗ Corporate chapter 11

✗ Small business chapter 11

✗ Wage earner chapter 13

The Purpose of Bankruptcy



Debtor Assets



Debtor's Liabilities/
Creditor's Expected Payout

The Losses of Insolvency



Debtor Assets



Creditor Costs



Creditor Recovery

Avoiding Zero-Sum Competition Costs



Avoiding Zero-Sum Competition Costs Before, After, and During Bankruptcy

- Prohibitions on *ipso facto* provisions – you can't negotiate with/coerce the debtor to favor you ahead of other creditors before the debtor becomes insolvent.
- Prohibitions on preferential transfers – you can't negotiate with/coerce the debtor to favor you after the debtor becomes insolvent but before bankruptcy.
- Enforcement of the automatic stay – you can't negotiate with/coerce the debtor to favor you after the debtor files for bankruptcy.

The Math of Deterrence



Benefit of Taking the Action



Cost of Taking the Action

~~Don't Do It!~~
Go For It!

Rational Decision

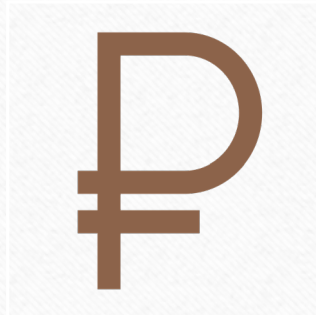
What is “Ordinary Course”?

The absence of extraordinary efforts to collect, prompted by knowledge of the debtor’s insolvency and a desire to shift losses onto other creditors.

Historical Intent Requirements



1800, 1841: Debtor acted in
“contemplation of bankruptcy”

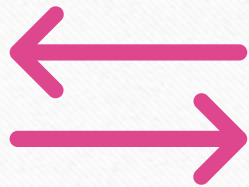


1867: Debtor acted “with a view to give a
preference” and creditor had “reasonable
cause to believe” of debtor’s insolvency



1898-1978: Creditor has “reasonable
cause to believe” debtor was insolvent at
time of the transfer

How Could the Law on Preferential Transfers Be More Effective?



Redefine “Ordinary”
Course Transfers



Give Creditors Control
over Preferences



Offer Creditors a Bounty
for Involuntary Filings

Questions?

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