Looking Backward, Looking Forward and Preference Liability in Reorganization Bankruptcies

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Introduction

The law on preferential transfers is one that scholars love to hate and with good reason. At its worst, preference avoidance functions as a highly inefficient mechanism to capriciously redistribute wealth, often away from unsuspecting and unsophisticated players.[1] At its best, the avoidance of preferential transfers funnels resources into litigating whether prior legitimate debt payments should be unwound at a time when the ongoing viability of the debtor is at stake, a potentially fruitless and costly endeavour. The law thus invites the debtor, its creditors and the court to turn their attention and energies to transactions that occurred in the past, rather than looking forward to the future. Bankruptcy is intended to encourage the future productive use of capital and assets, making this backward-looking approach apparently counterproductive.

A preferential transfer is an avoidable action in bankruptcy. This means that the transfer, which takes place before the bankruptcy filing, can be clawed back during bankruptcy proceedings. A preferential transfer is therefore like a fraudulent transfer, but it is also fundamentally different because preference avoidance requires no proof of intent nor any demonstration that the transfer was not given for a reasonably equivalent value. Under preference law as presently interpreted, an otherwise fully legitimate transfer made by parties innocent of any wrongful intent can be and often is unwound. Avoidance actions may be brought in every type of bankruptcy – consumer and commercial, liquidation and reorganization. This makes preference avoidance

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1 *See* David A. Lander, *Is Preference Litigation Worth Its Cost? Toward a Data-Based Answer*, 11 Norton Bankr. L. Advisor (2019). Not surprisingly, Lander's conclusion is that preference litigation is not worth the cost, insofar as it does not result in the more equitable sharing of the debtor's assets, recovers only a fraction (about 15%) of the total avoidable sum, and does not meaningfully increase the amount available for distribution. *Id.*

one of the most prominent and controversial causes of action raised in bankruptcy proceedings.

The purposes of preference law have been an enigma[2] to scholars for many years. But as Professor Richard Squire and I argue elsewhere,[3] the logic underlying the avoidance of preferential transfers is rooted in one of the primary purposes of business bankruptcy law. That same logic also informs other key provisions of the U.S. Bankruptcy Code, like the automatic stay. The purpose of both preferential transfers and the automatic stay is to discourage or disable creditors from engaging in zero-sum competition for a debtor's assets when the debtor is insolvent. The expenses that creditors incur when engaged in such competition serve no purpose but to change the distribution of losses among them. The expenditure thus reduces creditors' overall net recoveries, leaving creditors collectively poorer. By discouraging such wasteful competition, bankruptcy law increases creditors' net recoveries *ex post*, which in turn reduces debtor borrowing costs *ex ante*.

The automatic stay renders all actions to collect against the debtor void or voidable, disabling creditors from engaging in collection efforts that would merely redistribute losses. It thus serves to minimize creditors' recovery costs by discouraging the expenditure of resources on zero-sum efforts to collect. Creditors cannot benefit themselves from post-filing collection efforts because any action taken to improve a creditor's position after a bankruptcy filing is rendered legally void by statute.[4] But neither are creditors prejudiced in their eventual recovery by the collection efforts of other creditors, which are likewise stayed and voided. Because no creditor can obtain an advantage over any other after the filing, no creditor need incur the costs of doing so. Just as the automatic stay polices creditor action after a bankruptcy filing, preference law polices the time before a filing, when the debtor is insolvent but not yet bankrupt. When preference law functions properly, it accomplishes the same ends as the automatic stay: denying creditors the fruits of efforts that serve merely to place themselves ahead of others in the zero-sum division of their insolvent debtor's assets.

Policing preferential transfers is more complex than policing violations of the automatic stay. To enforce the automatic stay, the court merely needs to ask whether an action falls within the scope of statutorily prohibited collection efforts. Such an action, having taken place after the filing, is automatically voided. With preferences, however, a transfer that would otherwise be validly recognized is only retrospectively designated

2 *See, e.g.,* Lawrence Ponoroff, *Bankruptcy Preferences: Recalcitrant Passengers Aboard the Flight from Creditor Equality*, 90 Am. Bankr. L. J. 329, 336 (2016) (quoting a famous phrase from Sir Winston Churchill).

3 A fuller description of our theory can be found in forthcoming co-authored articles.

4 *See* 11 U.S.C. § 362(a).

as a preferential transfer by operation of law because of the bankruptcy filing. Even if all parties recognize that the debtor is insolvent when a seemingly preferential transfer occurs, they cannot know whether the transfer will be avoidable; they must wait to see if the debtor enters bankruptcy during the relevant look-back period (one year for transfers to insiders, 90 days for everyone else).[5]

It is difficult to police creditors' pre-petition, post-insolvency efforts to compete for the debtor's funds because on the surface actions that should be designated as preferential transfers appear identical to completely innocent actions. Under our theory, the sole difference between a preferential transfer and any other pre-petition, post-insolvency transfer is the intent of the parties involved. Avoidable preferences should be limited to those resulting from a creditor's efforts to collect *because* of the debtor's insolvency. Although the creditor may pursue a preference merely to avoid taking a loss, the fact of the debtor's insolvency means that the creditor is not avoiding losses so much as shifting them onto others. This is the behaviour that the law should deter; liability should be cabined accordingly. But intent is hard to prove, more so for preferential transfers than for other laws intended to discourage zero-sum inter-creditor competition, like the automatic stay.

Creditors acting in violation of the automatic stay can be presumed to know of the debtor's insolvency; all should receive timely notice of the bankruptcy from the court, and insolvency is presumed in a voluntary bankruptcy filing.[6] All acts taken to collect against a debtor after the filing can thus be presumed intentional and rendered void. Deliberate violations of the automatic stay, where creditors had actual knowledge of the filing and there is proof beyond presumption of affirmative intent, are subject to additional actual and punitive damages.[7] Creditors are therefore incentivized to take notice of a debtor's bankruptcy filing and refrain from taking actions in violation of the automatic stay because there will be no benefits and real costs from doing so.

But for preference avoidance, knowledge of the debtor's insolvency is more difficult to prove because the action takes place in advance of any bankruptcy filing. A deliberate response to the debtor's insolvency is also more difficult to presume from creditor collection, which is a normal and expected behaviour following the extension of credit. The difficulty of proving the deliberate nature of a preferential transfer explains why an

5 Preferential transfers to non-insiders are defined as those made on or within 90 days before the bankruptcy filing date. 11 U.S.C. § 547(b). Transfers made to insiders while the debtor is insolvent up to a year before the bankruptcy filing may also be avoided as preferences. *Id.*

6 Notice may be provided electronically pursuant to recent amendments to the Federal Rules of Bankruptcy Procedure. *See* Fed. R. Bankr. Pro. 9036.

7 *See* 11 U.S.C. § 362(k).

intent requirement, which was present in the first preference statutes, was eventually abandoned and replaced with the current 'ordinary-course' exception. Our theory puts this history into context and harmonizes the law in a way that other explanations for the purpose of preference law cannot.

Policing preferences is also intractable because the deterrent effect is weak under current rules of enforcement and there are strong incentives for a party who might seek a preference to disregard the possibility of future preference liability. A debtor's insolvency does not always, or even usually, result in a bankruptcy.[8] Even if bankruptcy does follow insolvency, the timing of the bankruptcy is not usually assured or easily predicted. Transfers that occur more than 90 days before the bankruptcy, even if made while the debtor is insolvent, are not avoidable as preferences.[9] This means that most of the time, pressuring a debtor for repayment will have no negative legal consequences.

In fact, preference law's application in bankruptcy proceedings – but only there – presents a dilemma for those creditors who know of the debtor's insolvency. How is an individual creditor to respond? The creditor may wait patiently for the debtor to voluntarily file for bankruptcy. The debtor's bankruptcy would eliminate the creditor's need (and the creditor's ability, because of the automatic stay) to take any action to collect, aside from filing a proof of claim. It would also presumably unwind the preferential transfers given to other creditors who are engaging in a race to recover from the debtor. But if there is no bankruptcy filing, the creditor's patience will ensure that other creditors recover first, leaving less and possibly nothing to satisfy our hapless archetype. If the creditor instead engages in the race for the debtor's assets, the creditor will incur collection costs alongside fellow creditors. If collection is successful and the bankruptcy is never filed, the creditor will be better off collecting than waiting and permitting others to collect first. Thus, creditors are each individually incentivized to join the race to recover from the debtor so long as the debtor remains outside bankruptcy proceedings.[10] A third option might be to file an involuntary bankruptcy

8 Exact numbers of companies that fail outside bankruptcy proceedings are difficult to come by, as are the number of failed companies that were insolvent, but a little back-of-the-napkin math confirms that only a fraction go through bankruptcy. It is commonly estimated that roughly 20% of all American businesses fail in their first year. Going into 2024, there were about 4,500,000 new businesses in the U.S. If estimates are correct, that would amount to 900,000 failed businesses by the end of the year, not including the number of older businesses that also failed. In 2024, there were only 23,107 business bankruptcies filed. Press Release, U.S. Courts, *Bankruptcy Filings Rise 14.2 Percent* (February 4, 2025). Accordingly, the vast majority of businesses failed outside bankruptcy.

9 If the transfer is made to an insider, the preference period is extended to a full year before the bankruptcy filing. *See* 11 U.S.C. § 547(b).

10 For an examination of the effects of preference law on dynamic asset pools using game theory, *see* Barry E. Adler, *A Re-Examination of Near-Bankruptcy Investment Incentives*, 62 U. Chi. L. Rev. 575 (1995).

petition, but this raises its own challenges, including the risk of damages if bankruptcy relief is not granted and the filing harms the debtor's reputation.[11]

Collectively, bankruptcy is the better outcome for creditors when the debtor is insolvent because it provides an orderly system of distribution, saving creditors from incurring duplicative costs in attempting to recover against the debtor individually. Collection costs are likely to be higher when a debtor is insolvent than they would be otherwise, for at least two reasons. First, an insolvent debtor struggling to survive another day will try to conserve its cash and thus be more reluctant to make payments on past debts, requiring creditors to devote more energy to coercing or persuading the debtor to pay up. Second, each individual creditor will inevitably be in competition with other creditors for recovery, due to the debtor's scarcity of funds. Some may win (by being repaid) and some may lose, but all are incentivized to engage in the contest for the debtor's assets. When the costs of the competition are taken into account, creditors are collectively made worse off than if they all had opted for a bankruptcy payout.

Preference law is both reasonable and rational when viewed as a method for reducing creditor recovery costs by discouraging wasteful competitive efforts once the debtor is insolvent, even before the debtor's bankruptcy. More to the point, when described this way preference law is inherently forward looking, even though preference liability relies on a factual determination of past actions. When successful, the deterrent effect of preference law preserves creditor resources and minimizes the losses from insolvency because creditors operating in the shadow of the law will then choose to invest their resources in productive efforts rather than in zero-sum competition with other creditors. However, under the law as currently drafted and enforced, the deterrent effect does not operate as it should. Understanding the purpose for preference law helps to clarify how and why the law falls short in a way that previous literature has not yet accomplished. Preference law can and should be amended to more successfully steer creditors away from collectively wasteful recovery efforts during their debtor's insolvency to more productive pursuits.[12]

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11 *See generally* 11 U.S.C. § 303. For a discussion on the social costs of the reduction in involuntary bankruptcy filings, *see* Richard M. Hynes & Steven D. Walt, *Revitalizing Involuntary Bankruptcy*, 105 Iowa L. Rev. 1127 (2020).

12 As Professor Squire and I explain in a separate work, reforming preference law may also require a broader reformation of other portions of the Bankruptcy Code. Brook Gotberg & Richard Squire, 'The Insecure Creditor's Dilemma' (working paper, on file with the author).