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Legal Alert

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PREFERENTIAL TRANSFERS: HOW CREDITORS CAN LOSE FUNDS THEY COLLECTED BEFORE A DEBTOR'S BANKRUPTCY

Preferential transfers are counterintuitive. A person might receive payment for a valid debt, and perhaps be owed more, yet still be ordered to return those funds when the debtor subsequently files bankruptcy. What sort of legal alchemy is this? And why?

A fundamental policy of bankruptcy law is equal treatment for similarly situated creditors. The creditor who squeezes money from a debtor on the brink of bankruptcy should not fare better than creditors who gave the debtor more time. It matters not that the creditor acted legally—indeed, acted responsibly—in seeking payment. It also is irrelevant whether the payment resulted from legal or private debt enforcement, or the threat of enforcement, or even a friendly relationship with the debtor. Because such payments "prefer" certain creditors over others, they are known as "preferential transfers."

The Bankruptcy Code codifies this policy at 11 U.S.C. § 547. The statute establishes six elements:

(1) A **transfer of the debtor's interest in property**. The transfer can be voluntary or involuntary. In addition to direct payments, the transfer element is satisfied with the granting of a lien. The central inquiry is whether the transaction resulted in the debtor's bankruptcy estate having less value for other creditors.

(2) The transfer was to or for the **benefit of a creditor**. In certain circumstances, a co-debtor (such as a co-signer or guarantor) is considered a creditor. If the debtor made payments that benefited a co-debtor, then the co-debtor might be liable as having received a preferential transfer.

(3) The transfer was for an **antecedent debt**. A transfer made at substantially the same time as the debtor incurred the obligation to pay is not a preferential transfer. This protects, for example, most C.O.D. transactions.

(4) The transfer occurred while the debtor was **insolvent**, which means the debtor's liabilities exceeded the value of its assets. If the debtor was not insolvent, then the transfer did not harm other creditors. Insolvency is presumed for ninety days prior to the bankruptcy filing.

(5) The transfer occurred **within ninety days of the bankruptcy filing**, or within one year for transfers to an "insider." Insiders include the relatives of an individual debtor and officers of a corporate debtor. For most creditors, the payment is safe once ninety-one days have passed following receipt.

(6) The transfer allowed the creditor **to receive more than it would in a liquidation** of the debtor's assets. This protects most secured creditors, who in a liquidation would receive their collateral, so long as the security interests were properly perfected (and not the result of preferential transfers). Remember, the policy is equal treatment for *similarly situated* creditors, not all creditors.

If a bankruptcy court finds a preferential transfer, then the transfer is "avoided" and the assets (or their value) must be returned to the bankruptcy estate. Anyone who returns a preferential transfer is entitled to an unsecured claim, which will receive distributions on par with other unsecured creditors.

The Bankruptcy Code recognizes several affirmative defenses. Under the ordinary course defense, payments of business debts are not avoidable if received in the parties' ordinary course of business (subjectively ordinary) or according to ordinary business terms (objectively ordinary). A payment made within a standard thirty-day billing cycle would likely satisfy this defense.

Under the new value defense, a creditor is protected from liability to the extent it subsequently contributed additional assets to the debtor. In theory, the new value offsets the detriment of a preferential transfer with a corresponding benefit to other creditors. Where a debtor and creditor did repeat business during the preference period, the defense requires an accounting to determine the extent to which each preferential transfer was followed by a contribution of new value.

There are additional defenses and various nuances to preferential transfers. Please contact us if you receive a demand related to preferential transfers or would like assistance structuring your transactions to minimize the risk of preferential transfers.