- Bankruptcy Statistics
  - Bankruptcy Reports, Research and Testimony
    - **ABI**
    - General
    - U.S. Government
    - Dow Jones Trend Report
    - A Debtor World: Interdisciplinary Academic Symposium on Debt
  - Bankruptcy-Related Organizations
  - National Bankruptcy Review Commission Archive
  - Bankruptcy Visuals
  - Bankruptcy Research Database

PRINT THIS PAGE

E-MAIL THIS PAGE

News Room

Home → News Room → Bankruptcy Research Center → Bankruptcy Reports, Research and Testimony → ABI Testimony

A History of Bankruptcy Preferences

Written by:
Scott Blakeley
Blakeley & Brinkman
Los Angeles, California
SEBLAKELEY@aol.com

Introduction

A fundamental principle of bankruptcy law since its advent in the sixteenth century is equality of distribution. This principle disfavors transfers that benefit one creditor at the expense of other creditors. [*FN:* See, *e.g.* , Charles Segilson, The Code and the Bankruptcy Act, 42 N.Y.U. L. Rev. 292, 292 (1967): A cornerstone of the bankruptcy structure is the principle that equal treatment for those similarly situated must be achieved. It would be highly inequitable to disregard what transpires prior to the filing of the bankruptcy petition; to do so would encourage a race among creditors, engender favoritism by the debtor, and result in inequality of distribution. At bankruptcy, the bankrupt would be left . . . with only tag ends and remnants of unencumbered assets.] Preference laws are central to this principle and they are the primary instrument in achieving equality of distribution. The preference laws have evolved as an offshoot of fraudulent conveyance law, thus containing broad ethical pronouncements of sixteenth century English bankruptcy law and to standardized, technical rules of twentieth century American bankruptcy law. The focus of preference laws has shifted from the culpability of the debtor, to the culpability of creditors, to the present day standard of strict liability.

Preference laws seek to deter individual creditor action by threatening recapture of transfers made during the debtor's period of vulnerability. Closely associated with the tenet of equality of distribution is the bankruptcy policy of maximization of the bankruptcy estate. A larger distribution might be achieved through rehabilitation rather than liquidation. Preferential transfers result in diminishment of estate assets, thus frustrating decisions that would achieve maximization. [*FN:* See, e.g., Thomas H. Jackson, Avoiding Powers in Bankruptcy, 36 Stanford L. Rev. 725, 759 (1984): Such eve-of bankruptcy asset-grabbing may be detrimental to the collective interests of the creditors. By reaching back to undo the actions of the creditors, preference law deters such grabbing, thereby protecting the creditors = bargain. Therefore, preference law essentially prevents individual creditors from opting out of the transitional period before bankruptcy. It enforces the hypothetical creditors = bargain that justifies a collective proceeding in the first place.]

English Bankruptcy Law: Creation of the Preference

Since 1570, English law has prohibited transfers by a debtor for the purpose of defrauding creditors. The penalty imposed for the crime of a forfeiture of the property transferred and imprisonment of the debtor. [*FN:* 8 William Scarle Holdsworth, A History of English Law , 240 (1922); 3 Halsbury's Laws of England (4th ed. 1973).] The emergence of preference law was closely tied to the law of fraud. Although the concept of pro rata distribution appeared in the first comprehensive bankruptcy statute, The Statute of 13 Elizabeth, [*FN:* 13 Eliz., ch. 5 (1571).] the Statute was silent as to preferences. Early preference law developed through case authority. In 1584, equality of distribution was introduced as a fundamental principle of bankruptcy law in the *The Case of Bankrupts*. [*FN:* 76 Eng. Rep. 441 (K.B. 1584).] In his pronouncement, Lord Coke stated that "[T]here ought to be an equal distribution. . .; [for] if, after the debtor becomes bankrupt, he may prefer [a creditor] and defeat and defraud many other poor men of their true debts, it would be unequal and unconscionable, and a defect in the law." [*FN:* Id . at 473.] This principle of equality advanced by Lord Coke viewed preferential transfers as defeating the principle of fairness.

Later cases further developed the doctrine of equality of treatment of creditors. Lord Mansfield held that the debtor must not set himself up as the law-giver in bankruptcy distribution. [*FN:* Alderson v. Temple, 96 Eng. Rep. 384, 385 (K.B. 1768).] Therefore, transfers on the eve of bankruptcy were void [*FN:* See id .] where creditors had not demanded payment or threatened to bring suit. [*FN:* See Thomason v. Freeman, 99 Eng. Rep. 1026, 1028 (K.B. 1786).] Payments to creditors, on the eve of bankruptcy, who *had* threatened to collect their debts were not considered preferential.

In 1746 Parliament created a bona fide creditor law, intending to protect innocent creditors from avoidance payments. [*FN:* See 8 William Scarle Holdsworth, A History of English Law , 237 (2d ed. 1937).] Courts distinguished between good and bad transfers. In a good transfer:

> (1) the claim had to arise in a bona fide credit transaction and in the ordinary course of trade; (2) the payment had to be made in the ordinary course of trade; and (3) the creditor had to not know or have notice that the debtor at the time was bankrupt or insolvent circumstances. [*FN:* See Charles Jordan Tabb, Rethinking Preferences, 43 S.C. L. Rev. 981, 998 (1992).]

A bad transfer required debtor intent to benefit a creditor to the detriment of other creditors. [*FN:* See John C. McCoid, Bankruptcy, Preferences, and Efficiency: An Expression of Doubt, 67 Va. L. Rev. 249 (1981).] The ethical inquiry under English preference law focused principally on the *state of mind* of the debtor, not on the *actions* of the creditor. Under this analysis the aggressive creditor was rewarded:

> [I]f a bankrupt, in a course of payment pays a creditor, this is a fair advantage in the course of trade; or, if a creditor threatens legal diligence, and there is no collusion; or behind the sue a debtor; and he make an assignment of part of his goods; it is fair transaction, and what a man might do without having any bankruptcy in view . . . if done in the course of trade, and not fraudulent may be supported. [*FN:* 96 Eng. Rep. 384, 385 (K.B. 1768).]

The statute advanced a central theme in preference legislation: Preferential payments are contrasted with some sense of ordinary commercial practice. The goal of preference laws was to capture fraud and not unwind a transaction in the ordinary course. The focus of English bankruptcy law was *not* ensuring a mathematical pro rata distribution of assets, but rather, to prevent a debtor from creating his own form of distribution to creditors.

In 1869 Parliament drafted a preference provision into its bankruptcy legislation. The preference law provided that any payment made within three months of bankruptcy, for the purpose of giving the creditor a preference, was void. [*FN:* 32 & 33 Vict., ch. 71, sect. 92 (1869); Vern Countryman, The Concept of a Voidable Preference in Bankruptcy , 38 Vand. L. Rev. 713, 718 (1985).]

American Bankruptcy Preference Law

Switching continents, a central consideration in American preference legislation is the review of changing relationships (1) between debtor and its creditors, and (2) among debtor's creditors.

Early American Bankruptcy Law

1. The State's View

State regulation of preferential transfers began in the late eighteenth century. Under these laws, the debtor's state of mind was essential in determining a preference.

2. The Bankruptcy Act of 1800

The first American Bankruptcy was the Bankruptcy Act of 1800 [*FN:* 2 Stat. 19-21 (1800) ; Countryman, Supra note 14, at 718.] While fraudulent conveyances were included in the Act of 1800, preference actions were not.

3. The Bankruptcy Act of 1841

The Bankruptcy Act of 1841 [*FN:* Bankruptcy Act of 1841.] was the first to define and prohibit preferences. Any transfer by the debtor, within a two month reach back period, [*FN:* Bankruptcy Act of 1841, ch. 9, section 2, 5 Stat. 440.] was illegal if made for the purpose of benefitting a particular creditor. As a result of an illegal preference, the debtor would lose his discharge . [*FN:* See *Id.*] The Act of 1841 did not consider "state of mind" as an element in finding an illegal preference.

4. The Bankruptcy Act of 1867

The Act of 1867 [*FN:* 14 Stat. 517 (1867).] made it easier to find a preference.

In addition to extending the reach back period to four months, [*FN:* 14 Stat. 517, section 35 (1867).] it changed the "debtor's contemplation of bankruptcy" condition to the "debtor's insolvency or contemplation of insolvency." Insolvency, however, was not defined. The Supreme Court defined insolvency as a debtor's inability to meet debts as they come due. [*FN:* See *Id.*] The 1867 Act also added the "state of mind" condition requiring the creditor to have reasonable cause to believe the debtor was insolvent. [*FN:* See *Id.*]

A Technical Approach to Preferences

1. The Bankruptcy Act of 1898

The Act of 1898 [*FN:* 30 Stat. 544 (1898).] promulgated an elaborate scheme for regulating preferences. It is viewed as the key which ensured ratable distribution. Section 60a provided:

> [A debtor] shall be deemed to have given a preference if, being insolvent, he has procured or suffered a judgment to be entered against himself in favor of any person, or made a transfer of any of his property, and the effect of the enforcement of such judgment or transfer [would] be to enable any one of his creditors to obtain a greater percentage of his debt than any other such creditor of the same class.

The 1898 Act reflects a shift in preference philosophy from the debtor's moral duty to his creditors to the preferred creditor's moral duty to fellow creditors. The debtor's state of mind in making the preference become irrelevant. The focus was now on to state of mind of the creditor. A transfer was avoidable provided the preferred creditor has reasonable basis to believe that the payment would cause a preference. [*FN:* Section 3, 30 Stat. 544 (1898).] The preference laws were intended to punish bad creditors, *i.e.* those that know of the debtor's insolvency. The Act's shortfall was that it included an abstract definition of preference giving the courts too much flexibility in its application. [*FN:* See, *e.g.* , Kennard v. Behrer, 270 F. 661 (S.D.N.Y. 1920). Preferred creditor who assists the debtor in financial straits by restructuring notes is immune from attack notwithstanding the creditor's state of mind. Distinction made to preferred creditors who know there is insufficient money to go around for fellow creditors.]

The Act of 1898 also addressed the secret lien, whereby a debtor who provide a creditor with a security interest well before the reach back period but who did not perfect the lien until the eve of filing, would fall within the relation back doctrine. Under this doctrine, liens were viewed as arising during the four month reach back period and could thus, be avoided. A number of courts, however, refused to avoid the secret liens. These counts held that such creditors deserved to be paid. Congress amended the preference laws in 1910 and 1926 to strictly apply the relation back provision. Moreover, until recovery of the preferences, the creditor's claim would be disallowed.

2. The Chandler Act of 1938

The Chandler Act continues the trend to a more technical application of preference laws. The Chandler Act re-emphasizes that ratable distribution is the essence of bankruptcy laws and preference laws are the vehicle to achieve this. As with the Act of 1898, the focus of the legislation was avoidance of secret liens and last-minute liens, and its purpose was to prevent rewards to preferred creditors, insiders and creditors exerting economic pressure.

3. The Bankruptcy Reform Act of 1978

The Bankruptcy Reform Act fundamentally changed American preference law. [*FN:* See Thomas M. Ward & Jay A. Shulman, In Defense of the Bankruptcy Code's Radical Integration of the Preference Rules Affecting Commercial Financing , 61 Wash. U. L.Q. 1, 4 (1983).] The drafters of the Bankruptcy Reform Act created a preference law, section 547 of the Bankruptcy Code, [*FN:* A preference consists of a transfer of the debtor's property: 1. To or for the benefit of a creditor; 2. For or on account of an antecedent debt owed by the debtor prior to such transfer; 3. Made while the debtor was insolvent; 4. Made on or within 90 days before the date of the filing of the petition (one year for insiders); 5. That enables such creditor to receive more than such creditor would receive if the case were a case under chapter 7.] which was a precise, technical rule of definitions and numbered exceptions intended to avoid transfers that upset ratable distribution. Congress sought to simplify the preference laws and restrict court interpretation of these provisions through technical drafting and on rule-oriented approach. [*FN:* Barash v. Public Fin. Corp., 658 F.2d 504, 510 (7th Cir. 1981).] The rule shifts the onus of preference litigation from debtor to creditor.

The principle objective section 547 is:

> [T]wo-fold. 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 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 more important*, the preference provisions facilitate the prime bankruptcy policy of equality of distribution among creditors of the debtor. Any creditor that received a greater payment than others of his class is required to disgorge it so that all may share equally. The operation of the preference section to deter the "race of diligence" of creditors to dismember the debtor before bankruptcy furthers the second goal of the

preference section-that of equality of distribution. [*FN:* Barash v. Public Fin. Corp., 658 F.2d 504, 510 (7th Cir. 1981). Does this really promote equality? Creditors may hold on to the money knowing that so long as the debtor does not file 90 days after the filing they will be able to keep it. At worst, a preferred creditor will simply have to return the money.]

The significant additions and revisions to the preference law under the Bankruptcy Reform Act include the following.

a. Reasonable cause to believe

The Bankruptcy Reform Act made it easier to establish the existence of a preference by eliminating the requirement that the creditor have reasonable cause to believe that the debtor was insolvent (except for insider creditors). [*FN:* While Congress eliminated the creditor's state of mind, this did not prevent courts from looking to the nature of the transaction and the relationship of the parties. See, *e.g.* , Wyle v. C.H. Rider & Family (*In re* United Energy Corp.), 944 F.2d 589, 595 (9th Cir. 1991).] The state of mind element is eliminated, in part, out of concern that the innocent creditor exception conflicts with the policy of equality among creditors. [*FN:* See, *e.g.* , H.R. Rep. No. 595, 95-595 at 178 (1978), reprinted in 1978 U.S.C.C.A.N. 5787 (1978) To argue that the creditor's state of mind is an important element of a preference and that creditors should not be required to disgorge what they took in supposed innocence is to ignore the strong bankruptcy policy of equality among creditors. Finally, the requirement that the trustee prove the state of mind of his opponent is nearly insurmountable, and defeats many preference actions. The amount of litigation it causes is too great when the requirements itself does not further any necessary bankruptcy policy. It also defeats the policy of the preference section by limiting recoveries to only the most egregious cases.]

b. Vulnerability period shortened

The reach back period is shortened from 120 days to 90 days.

c. Presumption of insolvency

To aid the trustee in establishing a prima facie case of preference, the drafters added the provision the debtor is *presumed* insolvent within 90 days prior to the bankruptcy filing.

d. Bankruptcy court jurisdiction

All forms of preference actions may be commenced in the bankruptcy court where, presumably, the action will proceed more swiftly. [*FN:* 11 U.S.C. ' 105.]

e. Secret liens

Aimed at the secret lien, the Bankruptcy Reform Act also requires creditors to timely perfect their security interests. [*FN:* See Ray v. Security Mutual Fin. Corp. (*In re* Arnett), 731 F.2d 358, 363 (6th Cir. 1984): One of the principal purposes of the Bankruptcy Reform Act is to discourage the creation of > secret liens = by invalidating all transfers occurring within 90 days prior to the filing of the petitions. Thus, creditors are discouraged from waiting until the debtor's financial troubles become all-too-manifest before recording its security interests.]

f. Exceptions

The elimination of the creditor's state of mind element and the addition of the presumed insolvency of the debtor element broadens to scope of a preference. The drafters seek to limit the broadened scope with defined exceptions. Other than the "subsequent advance" exception, [*FN:* See 60c of the Bankruptcy Act of 1898.] exceptions are new to preference law. The exceptions are intended to leave intact those transactions that do not diminish the size of the estate.

The drafters enumerated seven exceptions from section 547. [*FN:* Those seven exceptions are commonly referred to as: (1) contemporaneous exchange; (2) ordinary course of business; (3) enabling loan; (4) subsequent advance; (5) improvement in position; (6) statutory lien; and (7) consumer's small business.]

Courts have struggled with the application of the law, especially the exceptions, spending much time analyzing the ordinary course exception.

The drafters continued the rule disallowing a creditor's preferenced claim until the creditor surrenders the preference. [*FN:* See 11 U.S.C. ' 502 (d).]

4. The 1984 Bankruptcy Amendments and Federal Judgeship Act ("BAFJA")

BAFJA eliminates the Areasonable cause to believe" standard for insider creditors. The 45-day rule contained in the ordinary course of business exception is eliminated. BAFJA is contrary to the trend of more precise, bright line-rules promulgated under the Bankruptcy Reform Act. For example, the elimination of the 45 day reoccurrence rule now allows any creditor to argue the transfer was not in the ordinary course of business.