Preference Litigation: Part I – What Did I Do Wrong?

(Editor's Note: Back in our very first issue of *The Arrow*, we discussed how preference litigation against creditors can constitute a real "triple whammy" — the loss of a customer, the loss of the balance owed on the account, and the loss back to the trustee of those funds which you managed to collect in the 90 days preceding the bankruptcy petition. This article is the first of a series dealing with preference litigation and the defenses that creditors can use against a trustee in bankruptcy who comes calling on them with an outstretched hand.)

The part of the Bankruptcy Code that defines what constitutes a preference is 11 U.S.C. 547. The trustee must prove all five elements in order to prevail against the creditor. The trustee may 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 filing of the petition (extended to one year in the case of transferees who are "insiders"); and 5) that enables the transferee/creditor to receive more than it would if the case were a case under Chapter 7 and the transfer had not been made, and the creditor received payment only to the extent provided by the provisions of the Code (in other words, a pro rata distribution from a Chapter 7 trustee).

The intent behind this section of the Bankruptcy Code is to allow for a fairer distribution of the debtor's assets. The drafters of the Code did not believe that it was fair for the creditor who pressed the hardest for payment to be preferred over those who went unpaid just prior to the petition. They deplored such creditors' maxims as "The squeaky wheel gets the grease." These drafters reasoned that if all of the funds that were available to the debtor just prior to the bankruptcy were put in a pool and paid out pro rata, the distribution would be more fair and equitable. At least, so the theory goes.

In practice, any creditor forced into the role of defendant in an adversary proceeding brought by the trustee to avoid preferences seldom thinks that the Code is fair in this regard. The typical reaction of such a creditor is, "What did I do wrong?" Ordinarily, the simple answer is, "Nothing." In fact, the creditor probably has been guilty of nothing more than good credit practices by maximizing its recovery from an insolvent or shaky debtor on the eve of bankruptcy. To refuse an offer of payment for fear it might become an avoidable preference, on the other hand, would make a creditor guilty only of stupidity.

We advise our clients that the five elements of an avoidable transfer are like a template with five holes. If the trustee places the template over the debtor's transfer to you, and all of the five elements show up within the holes, then the trustee will deem it an avoidable transfer and come after you. There is no guilt or wrongdoing of any kind involved.