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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 doing away with preference law in the context of bankruptcy reorganization.

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INTRODUCTION

Preferential transfer law in bankruptcy has long been the subject of significant controversy.¹ Particularly in business cases, creditors have consistently and strenuously objected to a trustee's ability in bankruptcy to avoid or reverse transfers from the debtor to a creditor made on account of a legitimate debt in the 90 days prior to bankruptcy.² The trustee can do so even if the payment was warranted and the transferee had no reason to suspect that the debtor would later enter bankruptcy,³ because preference law is one of strict liability.⁴

The following conversation is a common response by defendant creditors to preference proceedings. Soon after an attorney representing a corporate client in a chapter 11 bankruptcy filed an action to recover a preferential payment on a construction contract, he got a call from the secretary for the owner of the construction company. She said, with the tone of someone who expects to resolve the issue over the phone, "My boss has a few questions that he wants me to ask you. Do you dispute that we performed the construction work?"

"No."

"And we did a good job?"

"Yes."

"You don't have any problems at all with the work we did?"

"No."

"You don't dispute the amount of the invoice?"

1. See generally C. Robert Morris, Jr., *Bankruptcy Law Reform: Preferences, Secret Liens and Floating Liens*, 54 MINN. L. REV. 737, 737 (1970) ("The law is wrong. . . . [T]he law of preferences is not the appropriate vehicle for handling secret liens in bankruptcy."); Robert Weisberg, *Commercial Morality, the Merchant Character, and the History of the Voidable Preference*, 39 STAN. L. REV. 3, 4-5 (1986).

2. The validity of preferential transfers, but for the bankruptcy filing, distinguishes preferences from fraudulent conveyance actions, which have historically been much easier to defend as a matter of policy. See Robert Charles Clark, *The Duties of the Corporate Debtor to Its Creditors*, 90 HARV. L. REV. 505, 513 (1977) ("[F]raudulent conveyance law embodies a general ideal . . . of nonhindrance of creditors . . . made operational through the effectuation of the more specific ideals of Truth, Respect, and Evenhandedness as well as a general, residual prohibition of conduct which hinders creditors in attempting to satisfy their claims.").

3. Erwin I. Katz et al., *Types of Bankruptcy-related Disputes*, in ABI GUIDE TO BANKRUPTCY MEDIATION 11 (1st ed. 2005) ("Preference actions seem particularly unfair: creditors are often shocked to learn that they may have to repay money to a debtor for receiving payment that was lawful at the time but has become actionable upon the filing of bankruptcy."); Lissa Lamkin Broome, *Payments on Long-Term Debt as Voidable Preferences: The Impact of the 1984 Bankruptcy Amendments*, 1987 DUKE L.J. 78, 95 (observing that lenders objected to the removal of the intent requirement for preference law on the grounds that the law would be unfair if applied to unknowing creditors).

4. Note that strict liability applies only to initial transferees, not to subsequent transferees. Transfers may not be recovered from subsequent transferees that take for value, in good faith, without knowledge of the voidability of the transfer. 11 U.S.C. § 550(b) (2012). This Article generally assumes application to initial transferees.

“No.”

“And your client owed us the money it paid us?”

“Yes.”

“And you admit that we earned it?”

“Yes.”

“And you want the money back?!”

“Yes.”

At this point there was a lengthy pause. Then the secretary stammered, with some incredulity: “Okay, I’ll tell my boss.”⁵

This dismay is natural among creditors who are non-repeat players in bankruptcy contexts.⁶ Preference avoidance requires the creditor who received the targeted transfer (the “preferred creditor”) to return the value received from the debtor. In exchange the creditor gets a claim against the estate for a pro rata distribution of the debtor’s remaining assets. This often translates to exchanging full payment for pennies on the dollar, with the remaining debt discharged in bankruptcy. From the preferred creditor’s viewpoint, this exchange marks a dramatic loss of value.⁷ Preferred creditors who must disgorge these preferential payments naturally feel blindsided. By its nature, preference law targets transfers made with no intent to defraud other creditors, no reasonable cause to believe that the debtor so intended, and no knowledge or reason to believe that the debtor was insolvent at the time the funds were transferred.⁸ Payment is generally warranted and accepted in good faith, with no warning that a bankruptcy would thereafter commence and a preference action brought.

5. Conversation with Brent Wride, S’holder, Ray Quinney & Nebeker, in Salt Lake City, Utah (Feb. 6, 2013).

6. See Jennie D. Latta, *What Every Tennessee Lawyer Should Know About Preferential Transfers*, TENN. B.J., Oct. 1991, at 26 (noting that recipients of a trustee’s demand for return of a preference is generally met with outrage); see also Judy B. Calton & Seth D. Gould, *Defending a Preference Action*, MICH. B.J., July 1993, at 666 (“It is no wonder that clients hate preference actions.”).

7. This discount is commonly referred to as being paid in “bankruptcy dollars.”

8. See H.R. REP. NO. 95-595, at 178 (1977), reprinted in 1978 U.S.C.C.A.N. 5963, 6139 (“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.”); *Bankruptcy Act Revision: Hearings on H.R. 31 and H.R. 32 Before the Subcomm. on Civil & Constitutional Rights of the H. Comm. on the Judiciary*, 94th Cong. 1855 (1976) (“Logically and theoretically, the knowledge of the recipient of the preference has nothing to do with equality of distribution. Equality is determined by the fact that all creditors are being treated reasonably alike. So, if two creditors received a payment . . . and one had knowledge and one did not of the insolvency of the debtor, that has really no relevancy to equality of treatment.”); see also Lawrence Ponoroff, *Evil Intentions and an Irresolute Endorsement for Scientific Rationalism: Bankruptcy Preferences One More Time*, 1993 WIS. L. REV. 1439, 1449 (noting that any formulation of preferences that focuses on culpability is inappropriate because the values of preference law are threatened by transfers depleting the estate without regard to state of mind).

More surprisingly, even repeat players who might anticipate a preference action express disapproval and discomfort with preference proceedings.⁹ To the extent these players are general unsecured creditors in bankruptcy proceedings, they are likely to benefit from successful preference actions, because the money recovered will go to benefit the estate, and by extension, its unsecured creditors.¹⁰ Presumably, with a sufficient number of iterations, these repeat players would benefit more from preference law as recipients than they would lose by being the target of an occasional preferential transfer action. Thus, one would expect the law of preferences to be more popular among creditors, providing an occasional windfall and promoting the old adage that “equity is equality.”¹¹

Crucially, however, preference liability is not contingent on whether avoiding the preference would benefit the estate’s unsecured creditors.¹² Whether there is a return for unsecured creditors does not inform the elements of preference liability or the exceptions thereto, although it is likely to inform a trustee’s decision to pursue such an action.¹³ Rather, the standard for a preferential transfer is whether the transfer made the preferred creditor better off than it would have been otherwise.¹⁴ If so, the transfer should be returned to the estate to ensure that all similarly situated creditors receive assets on the same pro rata basis.¹⁵ Accordingly, this standard promotes

9. See John Haggerty, Remarks at Field Hearing, ABI Annual Spring Meeting (Apr. 19, 2013), available at <http://commission.abi.org/minutes> (download “April 19, 2013 Washington, D.C.”) (“I think bankruptcy has lost credibility with the general trade. . . . They don’t have confidence in the process, for whatever reason, but when you talk to them about why they don’t, they’ve all been chased by frivolous, spurious preference claims. The cost runs away.”).

10. In some circumstances courts have permitted the pursuit of avoidance proceedings that did not profit unsecured creditors, but instead went to pay for the costs of administration. These cases have been the subject of some controversy. See *infra* note 12 and accompanying text.

11. See *Canright v. Gen. Fin. Corp.*, 35 F. Supp. 841, 844 (E.D. Ill. 1940), *aff’d*, 123 F.2d 98 (7th Cir. 1941); Adam J. Levitin, *Bankrupt Politics and the Politics of Bankruptcy*, 97 CORNELL L. REV. 1399, 1454 (2012) (noting that bankruptcy policy is built around the distributional norm that “similar creditors should have similar recoveries”); Ponoroff, *supra* note 8, at 1447 (“Bankruptcy law must regulate preferences precisely because preferential transfers belie the bankruptcy maxim that ‘equality is equity.’”).

12. See *Mellon Bank, N.A. v. Dick Corp.*, 351 F.3d 290, 293 (7th Cir. 2003) (noting that trustees may only recover avoided transfers “for the benefit of the estate,” but this does not require a benefit to unsecured creditors); *Harstad v. First Am. Bank*, 39 F.3d 898, 905 (8th Cir. 1994) (finding that a trustee or DIP is not required to demonstrate a direct benefit to creditors from preference recovery); Thomas D. Goldberg, *Curbing Abusive Preference Actions: Rethinking Claims on Behalf of Administratively Insolvent Estates*, AM. BANKR. INST. J., May 2004, at 14.

13. See *infra* notes 177–81 and accompanying text.

14. See 11 U.S.C. § 547(b)(5) (2012).

15. Pro rata distribution simply means that each creditor receives assets that amount to the same percentage of the amount owed as all other creditors. For example, if the estate owes \$1000 to three creditors in the amounts of \$500, \$300, and \$200, respectively, and the estate distribution totals \$500, all creditors would receive 50% of the amount owed as distribution, the first \$250, the second \$150, and the third \$100. Although such a distributional scheme is largely intuitive to those within the American legal system, other methods of distribution have been used

“fairness” by assuring that no single creditor gets a larger percentage return than others. However, the generally negative response to the law of preferential transfers suggests that the underlying policy of preference law, its implementation, or both, are flawed, and real reform is necessary.

Some of the primary objections to preference law focus on the costs associated with a preference action, for both the debtor’s estate and the targeted creditor,¹⁶ particularly in light of the many confusing and uncertain exceptions for which a given transaction may or may not qualify.¹⁷ These costs have led some creditors to view preference claims as “nothing more than nuisance litigation,”¹⁸ requiring a quick settlement to avoid costs in spite of potential defenses.¹⁹ These costs can be traced largely to conflicts raised by the implementation of distinct policies informing preference law.

From a policy standpoint, preference law is internally inconsistent. On the one hand, it purports to be a law of strict liability intended to ensure equal distribution: regardless of the merit of any particular creditor or transaction,

across history and cultures. For example, under Jewish law, an estate would be divided among unsecured creditors equally up to the amount of their debt, with the consequence that smaller creditors would receive a higher proportionate payout. For example, in the case of three creditors with claims of \$300, \$200, and \$100, a \$500 estate would be distributed by first giving each creditor \$100, satisfying C’s claim in full, and then dividing the remaining \$200 between A and B, paying B in full and leaving A with a \$100 deficit. See Louis Edward Levinthal, *The Early History of Bankruptcy Law*, 66 U. PA. L. REV. 223, 234 (1918).

16. See Comments of Kathy Tomlin, *ABI Commission to Study the Reform of Chapter 11*, AM. BANKR. INST. (May 21, 2013), http://commission.abi.org/sites/default/files/statements/21may2013/KathyTomlin_Testimony.pdf (“Defending against preference demands is a very time-consuming and expensive exercise. . . . All of us . . . are frustrated by the time and the cost required to sort out the merits of a preference demand and evaluate our defenses.”); David Lander & Thompson Coburn, *A Snapshot of Recent Avoidance Cases*, NORTON BANKR. L. ADVISER, Feb. 2004 (suggesting that defendants in preference actions are often dubious that the net total of preference recoveries significantly increases distribution to unsecured creditors).

17. See Comments of Kathy Tomlin, *supra* note 16 (“Many credit professionals are confused by the preference statute, particularly the various defenses available to creditors.”). Although in most circumstances such a concern is best met with a more careful revision or narrowing of exceptions, here the exceptions are problematic primarily because they seek to promote policies that are at odds with the underlying purpose of the statute. Accordingly it is not clear that any amendment or clarification would resolve the underlying tension.

18. Statement of David Pollack, *ABI Commission to Study the Reform of Chapter 11*, AM. BANKR. INST. (June 4, 2013), http://commission.abi.org/sites/default/files/statements/04jun2013/ABI_Field_Hearing_Transcript_6-04-13_Final.doc.

19. Written Statement by National Ad Hoc Group of Bankruptcy Practitioners in Support of Venue Fairness (Nov. 22, 2013), <http://commission.abi.org/sites/default/files/statements/22nov2013/Written-Venue%20Statement-for-ABI-Commission.pdf> (“[W]e sometimes . . . agree to pay all or a portion of a preference demand simply to avoid the high costs of defending against a preference claim, which can exceed the amount of preference liability in controversy” (citing Testimony of Joe Chiavone)); Deborah L. Thorne & John T. Gregg, *A Partial Solution to “Preference Litigation Run Amok,”* AM. BANKR. INST. J., Nov. 2007, at 22, 22 (“The filing of avoidance actions without prior reasonable due diligence is often considered tantamount to extortion because litigation costs in some adversary proceedings may exceed the amount of the alleged liability unless a settlement can be achieved at the outset of the adversary proceeding.”).

all similarly-situated creditors must share in the estate on a pro rata basis.²⁰ On the other hand, it discriminates in favor of certain creditors by establishing exceptions to the rule of strict liability,²¹ and also by permitting the trustee of the bankruptcy estate, which in reorganization cases may be the debtor itself,²² broad discretion in deciding which preferential transfers to avoid. These inconsistencies contribute to problems with both carrying out and legitimizing preference law. Exceptions—and the breadth of their scope—open the door to litigation, imposing significant costs on the estate in its efforts to pursue preferences.²³ The availability of defenses also encourages creditors to view preference law as an unfair imposition, rather than an equitable inevitability. Departures from the theory of strict liability and absolute equality of distribution belie the accepted underlying rationale for preference actions. The difficulty in predicting when exceptions will protect a transfer and when they will not also encourages the view that preference law is arbitrary and capricious, despite its stated pursuit of equality.

The introduction of alternative bankruptcy policy goals justifies the deviation from preference law's policy to strictly enforce equality of distribution. These goals are the maximization of the debtor's estate for the benefit of creditors²⁴ and the continuation of the debtor as a going concern for the benefit of non-creditor third parties.²⁵ These two goals are frequently

20. Note that the standard is not whether the transfer reduced the overall sum available to other creditors, although many have argued that it should be. *See infra* note 51. Instead, the standard is whether the transfer made it possible for one creditor to receive a higher pro rata payment from the estate than it would have otherwise. *See* 11 U.S.C. § 547(b)(5) (2012). In other words, it is irrelevant to equal distribution whether the preferred creditor added to the overall estate prior to receiving the transfer.

21. *See* 11 U.S.C. § 547(c). For example, the “ordinary course of business” exception tends to protect creditors with whom the debtor has an ongoing, long-term relationship. *See infra* notes 111–19 and accompanying text. There is also an exception on behalf of recipients for domestic support obligations. *See* 11 U.S.C. § 547(c)(7).

22. *See infra* notes 185–88.

23. *See* CHARLES JORDAN TABB, *THE LAW OF BANKRUPTCY* 524 (2d ed. 2009); *see also* Calton & Gould, *supra* note 6, at 666, 669 (suggesting that trustees may be convinced to abandon or settle cases for nominal payment where creditors' defense counsel can clearly articulate defenses).

24. ELIZABETH WARREN ET AL., *THE LAW OF DEBTORS AND CREDITORS: 2013 CASEBOOK SUPPLEMENT* 9 (6th ed. 2013) (noting that bankruptcy theorists all agree that a major goal of bankruptcy is to preserve economic value, even in liquidation); Richard V. Butler & Scott M. Gilpatric, *A Re-Examination of the Purposes and Goals of Bankruptcy*, 2 AM. BANKR. INST. L. REV. 269, 270–71 (1994) (noting bankruptcy law is intended to overcome the “common pool” problem, under which individual creditor collection rights could destroy part of the debtor's value for other creditors); James Steven Rogers, *The Impairment of Secured Creditors' Rights in Reorganization: A Study of the Relationship Between the Fifth Amendment and the Bankruptcy Clause*, 96 HARV. L. REV. 973, 975 (1983) (stating the central assumption of bankruptcy reorganization is that an enterprise will be more valuable as a going concern, and reorganization proceedings are intended to preserve this additional value for the benefit of creditors).

25. This goal is substantially more controversial, and forms the basis for a significant division among bankruptcy scholars. *Compare, e.g.*, Butler & Gilpatric, *supra* note 24, at 281–82 (noting

pursued under the guise of deterring aggressive creditor collection against struggling debtors, an oft-stated secondary purpose for preference law.²⁶ The argument is that preference law is necessary to deter creditors from inappropriately grabbing debtor assets in the days leading up to bankruptcy (a “bad” preference), and on the flip side, to encourage creditors to continue doing business with the debtor in the days leading up to bankruptcy (a “good” preference).²⁷ Viewed in this light, bankruptcy should encourage the avoidance of bad preferences, but should leave good preferences in place.²⁸ In making this argument, policymakers often seem unaware of the contradiction between the strict liability underlying the concept of equal distribution and the intent-based justification for deterrence.²⁹ Other commentators have acknowledged the tension between the principle of equal

that a business' going concern value is only partly captured by the recovery it can provide for its creditors, and also comprises relationships with non-creditor third parties, suggesting an independent bankruptcy interest in preserving this value), and Elizabeth Warren, *Bankruptcy Policy*, 54 U. CHI. L. REV. 775, 787-89 (1987) (arguing that chapter 11 satisfies an important policy interest in permitting the continuation of a debtor despite a creditor's interest in shutting the business down, because other actors could have an interest in the debtor's ongoing survival), with THOMAS H. JACKSON, *THE LOGIC AND LIMITS OF BANKRUPTCY LAW* 24 (1986) (arguing that bankruptcy law should be limited to concerns of how to maximize the value of a given pool of assets, not to how those assets should be distributed), and Douglas G. Baird, *Loss Distribution, Forum Shopping, and Bankruptcy: A Reply to Warren*, 54 U. CHI. L. REV. 815, 822 (1987) (arguing that the rules determining loss distribution inside and outside bankruptcy should be the same, suggesting no independent policy interest in the continuation of a failing debtor); see also H.R. REP. NO. 95-595, at 220 (1977), reprinted in 1978 U.S.C.C.A.N. 5963, 6179.

26. See A. Ari Afilalo, *The Impact of Union Bank v. Wolas on the Ordinary Course of Business Defense to a Trustee's Avoiding Powers*, 72 B.U. L. REV. 625, 635, 637 (1992) (explaining that the ordinary course of business exception ultimately is aimed at deterrence, with the primary purpose of “allowing a troubled debtor to pay its creditors and to continue its business activity”); Charles Jordan Tabb, *Rethinking Preferences*, 43 S.C. L. REV. 981, 987 (1992) (stating that the result supposedly achieved by deterrence is “maximization of the value of the debtor's assets”).

27. See Tabb, *supra* note 26, at 982-83.

28. See Michael J. Herbert, *The Trustee Versus the Trade Creditor: A Critique of Section 547(c)(1), (2) & (4) of the Bankruptcy Code*, 17 U. RICH. L. REV. 667, 691-92 (1983) (arguing that trade creditors who recognize a buyer's drift into bankruptcy but nonetheless continue to do business with the debtor deserve significant protection from preference liability).

29. See *Union Bank v. Wolas*, 502 U.S. 151, 162 (1991) (“[E]ven if we accept . . . that the availability of the ordinary business exception to long-term creditors does not directly further the policy of equal treatment, we must recognize that it does further the policy of deterring the race to the courthouse and, as the House Report recognized, may indirectly further the goal of equal distribution as well.”); S. REP. NO. 95-989, at 88 (1978), reprinted in 1978 U.S.C.C.A.N. 5787, 5874 (the general policy of preference law is deterring “unusual action” by the debtor or creditors); H.R. REP. NO. 95-595, at 178 (“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.”); see also H.R. REP. NO. 95-595, at 178 (“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.”).

distribution and competing policies,³⁰ and have argued for the promotion of one over the other.³¹

This Article argues that the policy goals associated with preference law—equal distribution, estate maximization, and debtor survival—cannot be satisfactorily balanced by a general preference law that is applicable across chapters. Equal distribution, although it forms the underlying justification for pursuing preferences in the first place, is consistently undermined by the other important policies, particularly in the context of debtor reorganization. To reconcile the two, the law has established a series of exceptions that eat away at preference liability, until the original purpose is no longer clear or defensible. Instead, preference actions in business bankruptcy cases³² should be abandoned in the reorganization context, where equal distribution is subordinate to more important policy goals, and returned to its originally intended form in liquidation cases, where it can again promote equality among all similarly situated creditors. The policy interest in ensuring equal distribution is still powerful in the liquidation context. Removing exceptions that interfere with this policy will both reduce costs and better harmonize this policy with the broader bankruptcy goal of estate maximization.

This Article will proceed in three parts. Part I sets forth the law of preferential transfers, its understood purpose or purposes, the basic standard and exceptions set forth in the Bankruptcy Code, and an explanation for how preference actions are pursued in the various bankruptcy chapters. Part II evaluates the conflicting policies that inform preference proceedings and the

30. See, e.g., Broome, *supra* note 3, at 78 (“The focus of preference law . . . has not been consistent.”); John C. McCoid, II, *Bankruptcy, Preferences, and Efficiency: An Expression of Doubt*, 67 VA. L. REV. 249, 252–53 (1981) (“The distinction between a deliberate preference that may be recaptured and other transfers with preferential effect that are invulnerable does not mesh neatly with the announced purpose of bankruptcy law to provide equal distribution among creditors.”); Thomas J. Palazzolo, *New Value and Preference Avoidance in Bankruptcy*, 69 WASH. U. L.Q. 875, 881, 883 (1991) (arguing that the new value exception was intended to encourage creditors to continue to do business with a troubled debtor, but this policy undercuts the goal of equality of distribution among creditors); Ponoroff, *supra* note 8, at 1450 (suggesting that “the lack of coherence” in preference exceptions is symptomatic of confusion surrounding the basic consequential objectives of preference law); Tabb, *supra* note 26, at 987 (noting that the two policies of equality and deterrence “conflict at times”).

31. See, e.g., Afilalo, *supra* note 26, at 635 (“The ultimate objective of preferences law is not absolute equality.”); Broome, *supra* note 3, at 79 (“Although a preference provision aimed only at preventing inequality may incidentally deter the scramble for advantage, the Code reflects the judgment that the deterrence objective should not limit the scope of the trustee’s avoiding power.”); Tabb, *supra* note 26, at 987.

32. As explained below, this Article generally restricts itself to an analysis of preference law in the business context, in connection with filings under chapter 7 and chapter 11, where it is most likely to arise. See *infra* Part II.C. It should be noted that a different set of policy expectations arises in the context of individual consumers; for example, there is no distinction in the expectation of the individual debtor’s survival post-bankruptcy, whether the case is one of liquidation in chapter 7 or reorganization in chapter 13. In either scenario, policy is concerned with the individual debtor’s ability to function as a “going concern.”

exceptions thereto, particularly how the policies of estate maximization and debtor survival as a going concern have shaped preference law and affected equal distribution among creditors. Part III proposes abandoning traditional preference avoidance in reorganization cases, and reestablishing a law of strict and universal preference liability in liquidation cases. This Article is a thought experiment, not a legislative proposal. It is intended to test the policy justification behind the current legal structure, and suggest an alternative direction.

I. PART ONE: THE LAW OF PREFERENTIAL TRANSFERS

As explained by Charles Tabb in his influential treatise on bankruptcy, “[g]enerally speaking, a preference is a transfer that favors one creditor over others.”³³ More specifically, a preference is a transfer in the period prior to a bankruptcy filing (90 days for general creditors, one year for insiders) that makes the recipient better off than it would have been pursuant to a pro rata distribution of the bankruptcy estate had the transfer never taken place.³⁴ These transfers can be avoided or unwound, such that the value transferred out of the bankruptcy estate is returned to satisfy estate creditors on a pro rata basis. Its purpose is therefore to preserve the general theory of bankruptcy that creditors should be treated equally, as long as they are similarly situated, in the course of administering a bankruptcy estate.³⁵ The basic standard for preferential transfers is strict liability for initial transferees,³⁶ with closely

33. TABB, *supra* note 23, at 486.

34. See 11 U.S.C. § 547(b) (2012).

35. See S. REP. NO. 95-989, at 49 (1978), reprinted in 1978 U.S.C.C.A.N. 5787, 5835 (“Bankruptcy is designed to provide an orderly liquidation procedure under which all creditors are treated equally.”); Melissa B. Jacoby, *The Bankruptcy Code at Twenty-Five and the Next Generation of Lawmaking*, 78 AM. BANKR. L.J. 221, 222 (2004) (identifying “equal treatment of similarly-situated creditors” as one of the “oft-cited substantive goals of bankruptcy”); Charles Seligson, *The Code and the Bankruptcy Act: Three Views on Preferences and After-Acquired Property*, 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.”).

36. See *supra* note 4. As others have pointed out, preference law was not always one of strict liability; rather, historically, it more closely resembled the law of fraudulent conveyances. See, e.g., Vern Countryman, *The Concept of a Voidable Preference in Bankruptcy*, 38 VAND. L. REV. 713, 716–18 (1985); McCoid, *supra* note 30, at 250; Ponoroff, *supra* note 8, at 1448 n.21; Weisberg, *supra* note 1, at 4; see also Bankruptcy Act of 1898, ch. 541, § 60(b), 30 Stat. 544, 562 (repealed 1978) (declaring a preference avoidable only if the person receiving the transfer “shall have had reasonable cause to believe that it was intended thereby to give a preference”); Bankruptcy Act of 1867, ch. 176, § 35, 14 Stat. 517, 534 (repealed 1878) (declaring void and avoidable transfers made in contemplation of insolvency with a view to give a preference, with the existence of such transfers made outside the usual and ordinary course of business prima facie evidence of fraud); Bankruptcy Act of 1841, ch. 9, § 2, 5 Stat. 440, 442 (repealed 1843) (declaring void and fraudulent all transfers of property made in contemplation of bankruptcy and for the purpose of giving a preference). The decision to move away from the intent requirement was informed by the 1973 Report of the Commission on the Bankruptcy Laws of the United States, [hereinafter “1973 Report”] which indicated that the intent requirement was “the most troublesome feature” of current preference provisions, leading to much litigation, and that “intention should be

defined rules for its application and its exceptions. In theory, it applies to all transfer recipients, regardless of culpable intent, financial need, or particular status.³⁷ However, as explained below, preference liability is subject to important exceptions that discriminate between creditors pursuant to various alternative policy objectives.

A. THE PURPOSE OF PREFERENCE LAW

1. Equal Distribution

The purpose of preferential transfers is tied up in the purposes of bankruptcy law, and in particular, the distributional theory of bankruptcy.³⁸ Assisted by the automatic stay, which prohibits creditors from collecting on individual debts the moment a debtor files for bankruptcy,³⁹ bankruptcy law forces creditors into a pro rata system of distribution.⁴⁰ It does not permit creditors to side-step bankruptcy procedures to obtain a greater proportion of the bankruptcy estate than they would otherwise receive⁴¹ in liquidation⁴² or under a plan.⁴³ Instead, with certain exceptions,⁴⁴ creditors can only

irrelevant.” REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, H.R. DOC. NO. 93-137, pt. 1, at 214-15 (1973). “That [intent] requirement, more than any other, has rendered ineffective the preference section of the present Act.” *Id.* at 203-04.

37. See *Cent. Va. Cmty. Coll. v. Katz*, 546 U.S. 356, 359 (2006) (holding that sovereign immunity is not a defense to a preferential transfer action).

38. See Weisberg, *supra* note 1, at 3 (“Preference doctrine would seem to be a central part of bankruptcy law. If the general purpose of bankruptcy law is to ensure a ratable distribution of the debtor’s assets among the creditors, preference law would seem, by definition, to be a primary instrument for achieving that goal.”).

39. 11 U.S.C. § 362(a) (2012); see also Daniel Keating, *Offensive Uses of the Bankruptcy Stay*, 45 VAND. L. REV. 71, 75 (1992).

40. For a justification of bankruptcy’s departure from rules rewarding a race of diligence outside of bankruptcy, see Tabb, *supra* note 26, at 988.

41. See David Gray Carlson, *Security Interests in the Crucible of Voidable Preference Law*, 1995 U. ILL. L. REV. 211, 216.

42. Liquidation of a debtor’s assets is generally accomplished through a chapter 7 filing, in which an independent trustee is appointed to administer and distribute the estate. See generally WILLIAM D. WARREN ET AL., *BANKRUPTCY* 21 (9th ed. 2012).

43. Bankruptcy law also permits qualifying debtors to reorganize their affairs and make payments on pre-petition debts pursuant to a bankruptcy plan, as overseen by the court. This is typically accomplished in chapter 13 for individual consumer debtors, and in chapter 11 for businesses. Chapter 12 provides reorganization for family farmers or fishermen. See *id.* at 21-23.

44. The Bankruptcy Code has identified certain debts as nondischargeable, by nature of the debt or in response to the bad actions of the debtor before or during the bankruptcy proceeding. For example, many taxes and governmental fines are nondischargeable, see 11 U.S.C. § 523(a)(1), (7), (14A) and (14B), as are debts obtained by fraud, see 11 U.S.C. § 523(a)(2), for fraud, see 11 U.S.C. § 523(a)(4), for domestic support obligations, see 11 U.S.C. § 523(a)(5), and for willful torts, see 11 U.S.C. § 523(a)(6). Unless a debtor can demonstrate that not discharging student loans would impose an undue hardship, such educational loans are also nondischargeable. See 11 U.S.C. § 523(a)(8).

recover from funds made available through the liquidation of the estate, or the funds dedicated to repayment of creditors in a plan of reorganization.

But not all creditors are treated equally in bankruptcy. Creditors who hold a security interest in estate assets or enjoy statutory priority status may be paid in full while others receive nothing.⁴⁵ However, there is a policy of preserving equal treatment within classes of debtors, and in particular, among non-priority unsecured creditors.⁴⁶ Congress has explicitly stated this policy,⁴⁷ and the Supreme Court has also recognized it,⁴⁸ as have other members of the judiciary.⁴⁹ Bankruptcy scholars have also agreed that bankruptcy is intended to promote equitable distribution,⁵⁰ even if they have different opinions about what that means.⁵¹

45. See *infra* notes 84–88 and accompanying text; see also 11 U.S.C. § 507 (listing the priority of expenses and claims). For a discussion on the history of wage priority in bankruptcy law, see C. Scott Pryor, *The Missing Piece of the Puzzle: Perspectives on the Wage Priority in Bankruptcy*, 16 AM. BANKR. INST. L. REV. 121, 122 (2008).

46. See Countryman, *supra* note 36, at 748 (noting that, while the stated purpose behind preference law in the legislative history is “equality of distribution,” bankruptcy only promotes a policy of preserving equality within classes); Edward S. Margolis, *Advantage to Creditor: Understanding Preference Actions and Available Defenses*, 93 ILL. B.J. 590, 590–91 (2005) (“The power to avoid preferences promotes the primary bankruptcy policy of equality of distribution among creditors by insuring that all creditors of the same class receive the same pro rata share of the debtor’s estate.”).

47. H.R. REP. NO. 95-595, at 340 (1977), reprinted in 1978 U.S.C.C.A.N. 5963, 6297 (“Bankruptcy is designed to provide an orderly liquidation procedure under which all creditors are treated equally.”).

48. See *Kuehner v. Irving Trust Co.*, 299 U.S. 445, 451 (1937) (noting that “the object of bankruptcy laws is the equitable distribution of the debtor’s assets amongst his creditors.”); *Kothe v. R.C. Taylor Trust*, 280 U.S. 224, 227 (1930) (“The broad purpose of the Bankruptcy Act is to bring about an equitable distribution of the bankrupt’s estate among creditors holding just demands based upon adequate consideration.”); see also *Sherwood Partners, Inc. v. Lycos, Inc.*, 394 F.3d 1198, 1203 (9th Cir. 2005) (noting that, along with the fresh start, chapter 7 of the Bankruptcy Code encapsulates the ideal of equitable distribution of the debtor’s assets “through a distinctive form of collective proceeding”).

49. See *In re Brook Mays Music Co.*, No. 06-32816-SGJ-11, 2007 WL 4960375, at *1 (Bankr. N.D. Tex. Aug. 1, 2007) (criticizing avoidance actions that fail to take into consideration “the underlying policies of the preference laws which, since Elizabethan times, have always been about promoting equality of distribution among similarly situated creditors and deterring overreaching”).

50. See Ralph Brubaker, *Bankruptcy Injunctions and Complex Litigation: A Critical Reappraisal of Non-Debtor Releases in Chapter 11 Reorganizations*, 1997 U. ILL. L. REV. 959, 968; Richard B. Levin, *An Introduction to the Trustee’s Avoiding Powers*, 53 AM. BANKR. L.J. 173, 184 (1979) (“Congress has chosen to eliminate the reasonable-cause-to-believe test from the ordinary preference situation. The goal of equality of distribution among creditors becomes paramount.”); Palazzolo, *supra* note 30, at 877; Seligson, *supra* note 35, at 292 (“A cornerstone of the bankruptcy structure is the principle that equal treatment for those similarly situated must be achieved.”).

51. For example, some see the purpose of equal distribution to ensure that no creditor is paid less as a consequence of a preferential transfer, although this is not the statutory standard. See H.R. Rep. No. 95-595, at 215 (“It may be thought that the core meaning of the entire preference concept is that the transfers which should be avoided are those which, if allowed to stand, would leave the estate available for distribution among creditors permanently depleted. If,

Preference law is a necessary extension of the normal bankruptcy restrictions on distribution that would give one creditor more than it gives another.⁵² It creates a look-back period of 90 days to ensure that the pro rata bankruptcy distribution will not be rendered moot by a disbursement of assets immediately before filing.⁵³ This concern that debtor or creditor activity immediately prior to a bankruptcy filing could undermine any subsequent bankruptcy distribution predates any codified preference law in the United States. Under the 1800 Bankruptcy Act, for example, courts inferred principles of preference doctrine from the existence of a bankruptcy law, with its strict principle of ratable distribution.⁵⁴ Even further back, English law recognized actions relating to preferential transfers in the late 16th century, justifying such actions on account of “a distrust of a bankrupt’s handling of his own assets and a principle of equal division among creditors.”⁵⁵

Because the purpose of preference law is to ensure equal distribution, and not to punish bad actors,⁵⁶ the standard is strict liability: “Any creditor that received a greater payment than others of his class is required to disgorge so that all may share equally,”⁵⁷ regardless of the creditor’s intent or influence in causing the preferential treatment. In fact, preference actions will typically only be used when the transfer was valid, the debt legitimately taken, and payment justifiably due. Transfers made without adequate compensation, or for the purpose of defrauding creditors, will provoke a fraudulent conveyance action, rather than a preference proceeding.⁵⁸ In preference law, the only

in a series of transactions between the (bankrupt) transferor and a transferee, the ‘net result’ is zero (i.e. no depletion), it seems unfair to penalize the transferee by holding each separate ‘transfer’ preferential without crediting him for the subsequent unsecured new value contributions he has made to the estate.”); *see also* Palazzolo, *supra* note 30, at 876.

52. *See* H.R. Rep. No. 95-595, at 178 (“[T]he preference provisions facilitate the prime bankruptcy policy of equality of distribution among creditors of the debtor.”); Broome, *supra* note 3, at 113; Rafael I. Pardo, *On Proof of Preferential Effect*, 55 ALA. L. REV. 281, 282 (2004) (“If the Code is to be applied equally to similarly situated creditors, ‘preferential transfers’ must be defeated.”).

53. *See* Countryman, *supra* note 36, at 748 (“The function of the preference concept is to avoid pre-bankruptcy transfers that distort the bankruptcy policy of distribution.”); McCoid, *supra* note 30, at 260–61 (“Preference law tries to impose equality on pre-bankruptcy behavior so that that behavior will not make the principle of equality in bankruptcy distribution meaningless.”); Weisberg, *supra* note 1, at 4 (“Bankruptcy law empowers the trustee and the court to enforce ratable distribution as a matter of public power; preference law implies that the debtor and creditor have a private duty to save the bankruptcy process from becoming moot before it has a chance to start.”).

54. *See* Weisberg, *supra* note 1, at 76.

55. *See id.* at 40–41 (citing *The Case of Bankrupts*, (1584) 76 Eng. Rep. 441, 473 (K.B.)).

56. *See* Countryman, *supra* note 36, at 748.

57. H.R. Rep. No. 95-595, at 178.

58. Recipients of transfers that are constructively fraudulent, in which there is no evidence of fraudulent intent, but the debtor received less than a reasonably equivalent value in exchange for the transfer, may also be innocent of any wrongdoing. Accordingly, an argument could be made that avoidance proceedings in the context of such fraudulent conveyances under 11 U.S.C.

violation is the timing of the payment:⁵⁹ if made during the 90 days before bankruptcy, it may be avoided.

2. Deterrence

Many also view preference law as a method to discourage creditors' over-hasty efforts to dismantle a struggling debtor, the proverbial "race to the courthouse."⁶⁰ This policy, when interpreted broadly, tends to conflict with the principle goal of equal distribution.⁶¹ The underlying justification of deterrence is to encourage the debtor's continued financial stability. This echoes both the desire to maximize the debtor's estate and to preserve the debtor's continuing operation as a going concern. When a debtor faces a financial downturn, creditors may justifiably fear for their prospects of repayment, prompting attempts to recover ahead of the rest of the pack. This behavior can only harm the debtor's financial position and may encourage a bankruptcy filing. However, the reasoning goes, if a creditor knows that last-minute efforts to recover may eventually be avoided in bankruptcy, the creditor will be more inclined to refrain from collecting, permitting the debtor space and opportunity to regain its financial footing. If this happens, all creditors will benefit and the matter will be resolved without the interference of the bankruptcy court.

The purpose of deterrence in preference law is generally understood to be subordinate to the primary purpose of ensuring equal distribution.⁶² This

§ 548(a)(1)(B) are also unfair and should be done away with. Such an argument is outside the scope of this Article; however, it should be noted that fraudulent conveyance law does not suffer from the internal inconsistencies described here. The law regarding fraudulent conveyances, even transfers that are only constructively fraudulent, is intended to and largely succeeds in maximizing the debtor's estate for the benefit of creditors by avoiding transfers in which the debtor has given value without receiving value in return. *See* CHARLES JORDAN TABB, *THE LAW OF BANKRUPTCY* 570 (3d ed. 2014) ("The focus is not on the rights of creditors vis-à-vis other creditors, as is true of preference law, but on the rights of creditors vis-à-vis the debtor.").

59. *Van Iderstine v. Nat'l Disc. Co.*, 227 U.S. 575, 582 (1913).

60. *See* H.R. Rep. No. 95-595, at 177-78 ("[B]y 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."). As suggested below, there has been some historic disagreement, still largely unresolved, as to whether deterrence is less important, as important, or even more important a policy consideration to preference law than equality of distribution. *See* REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, H.R. DOC. NO. 93-137, at 202 (1973) (listing "three distinct goals" for preference in the Bankruptcy Act of 1898: "First, it lessens the possibility of a scramble among creditors for advantage; second, it promotes equality; and third, it eliminates the incentive to make unwise loans in order to obtain a preferential payment or security").

61. *See infra* notes 120-22 and accompanying text.

62. *See* Broome, *supra* note 3, at 115 (finding that after 1978, the main goal of preference law was to preserve equality of distribution, with deterrence only an incidental objective); Carlson, *supra* note 41, at 216 ("[V]oidable preference law is singularly unconnected with going concern value."); Pardo, *supra* note 52, at 283; *see also* H.R. Rep. No. 95-595, at 177-78 ("The purpose of the preference section is two-fold. First, by permitting the trustee to avoid prebankruptcy transfers

may be due to the weakness of preference law as an effective deterrent. As others have noted,⁶³ a creditor has nothing to lose and everything to gain, by accepting or demanding a preferential payment. In the first place, even if the debtor is struggling financially at the time of the transfer, there is no guarantee that the transfer will push the debtor into bankruptcy. The decision to file for bankruptcy is complicated and strategic; often a debtor may avoid bankruptcy even if circumstances would otherwise justify a filing.⁶⁴ Even if the debtor does go into bankruptcy within the preference period following the transfer, there is no guarantee that the debtor will pursue an action because of the potential costs of the action and the potential damage to the debtor's relationship with the transferee.⁶⁵ Finally, even if a preferential action is brought, the transferee may be able to argue that one of the exceptions applies, which will at the very least raise the costs of pursuing the action and thereby discourage the trustee from pushing for a judgment.⁶⁶

The policy of deterrence encourages exceptions for transfers that promote economic activity between debtor and creditor. Put another way,

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. . . . Second, and more important, the preference provisions facilitate the prime bankruptcy policy of equality of distribution among creditors of the debtor.”); Tabb, *supra* note 26, at 987 (arguing that concerns of equal distribution “should be given ascendancy” over concerns of deterrence).

63. See, e.g., Carlson, *supra* note 41, at 216; Countryman, *supra* note 36, at 748.

64. See Michael Feder, *How About Bankruptcy? Uh, No: Why It's Not the Best Solution*, 15 BUS. L. TODAY 19, 19 (2006) (discussing concerns of control, oversight, and expense). Similarly, filing for bankruptcy can be used as a strategic tool to achieve specific business purposes. See KEVIN J. DELANEY, STRATEGIC BANKRUPTCY: HOW CORPORATIONS AND CREDITORS USE CHAPTER 11 TO THEIR ADVANTAGE 59 (1992).

65. See *Adelphia Comm. Corp. v. Bank of Am., N.A. (In re Adelphia Commc'ns Corp.)*, 330 B.R. 364, 373 (Bankr. S.D.N.Y. 2005) (“Debtors sometimes lack the inclination, or the means, to bring actions that should be prosecuted. They sometimes have higher priorities, or are distracted by other things. They sometimes have a practical need to avoid confrontation with entities like their secured lenders, because they need those entities’ continuing cooperation—as, for example, in connection with exit financing.”); Nancy Haller, Comment, *Cybergenics II: Precedent and Policy vs. Plain Meaning*, 56 ME. L. REV. 365, 384–85 (2004) (“A debtor-in-possession . . . may use the trustee provisions to favor certain creditors; may be unwilling to avoid transactions with a supplier or lender with whom it hopes to continue a business relationship after a successful reorganization; or may have developed friendships that make it difficult to choose to pursue actions with severe economic impacts.”); Alan R. Lepene & Sean A. Gordon, *The Case for Derivative Standing in Chapter 11: “It’s the Plain Meaning, Stupid,”* 11 AM. BANKR. INST. L. REV. 313, 317–18 (2003) (“DIPs frequently face conflicts where the duty to investigate and prosecute avoidance claims may involve family members, major shareholders whose support they may need post-reorganization, or current and past officers, directors, or other corporate insiders.”).

66. In some situations, a trustee may be held liable for sanctions under Bankruptcy Rule 9011 if the trustee brought a preference action without adequately investigating the availability of an affirmative defense. See *In re Excello Press, Inc.*, 967 F.2d 1109, 1112 (7th Cir. 1992) (ruling that at times a trustee may have a responsibility to examine whether any obvious affirmative defenses bar the case); Goldberg, *supra* note 12 (citing ethical reasons why a practitioner should not commence a preference action where there may be meritorious affirmative defenses); Margolis, *supra* note 46, at 592.

these exceptions permit some types of preferential transfers, but not others. The recipients of "good" preferential transfers are therefore better off than their fellow creditors, particularly those who received "bad," and therefore avoidable, preferences. A true policy of equality would avoid all transfers, whether "good" or "bad." The policy of deterrence accordingly conflicts with the policy of equal distribution.

B. ELEMENTS AND EXCEPTIONS

The elements of an avoidable preference, as defined by the Bankruptcy Code, require a transfer of the debtor's property to a creditor, on account of a previous debt, made during the 90 days prior to the filing of the bankruptcy petition, such that the creditor received more than it would have under a bankruptcy liquidation and distribution of the debtor's assets. The definition of "transfer" is intentionally broad; it includes straightforward transactions, such as cashing a check, and complicated transactions, such as the late perfection of a security interest granted months prior.⁶⁷ The remaining requirements, separated into five subsections, are carefully worded to minimize the litigation that follows many preference actions.

These five requirements are: (1) that the transfer be made "to or for the benefit of a creditor";⁶⁸ (2) that the transfer be "on account of an antecedent debt owed by the debtor before such transfer was made"; (3) that the transfer be made "while the debtor was insolvent"; (4) that the transfer be made within the 90 days before the date of the filing or between 90 days and one year prior to the filing, if the creditor is an insider; and (5) that the transfer "enables such creditor to receive more than such creditor would receive if" the transfer had not been made and the estate distributed according to the rules of a chapter 7 liquidation.⁶⁹ To the extent that these elements require further narrowing or clarification, the Bankruptcy Code cabins their scope through exceptions⁷⁰ and establishes a rebuttable presumption for insolvency during

67. Title 11 of the United States Code [hereinafter, the "Bankruptcy Code"], includes in the definition of "transfer" the following:

- the creation of a lien;
- the retention of title as a security interest;
- the foreclosure of a debtor's equity of redemption; or
- each mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with—
- property; or
- an interest in property.

11 U.S.C. § 101(54) (2012).

68. Pursuant to this language, preferences may be direct or indirect. See TABB, *supra* note 58, at 506.

69. 11 U.S.C. § 547(b).

70. Exceptions are discussed *infra* Parts II.B.1-2.

the 90-day preference period.⁷¹ Further, bankruptcy courts use a straightforward analysis to determine whether a creditor is made better off by virtue of the transfer: where the subject creditor is unsecured and without priority, the trustee must only show that the creditor would have received less than a 100% payout under the estate distribution.⁷²

Despite efforts to simplify the rules of preferential transfers, preferences are by far the most litigated of the avoidance powers exercised by the trustee.⁷³ Much of the litigation surrounding preference law deals with the exceptions to the rule. There are two types of exceptions: those that are intended to clarify and narrow the parameters of what constitutes a preference (“narrowing exceptions”), and those that seek to carve out particular creditors or transfers as protected from otherwise applicable preference law (“true exceptions”). There are four narrowing exceptions to the law of preferential transfers and seven true exceptions. Each is described briefly below.

1. Narrowing Exceptions

a. *Substantially Contemporaneous Exchange*

The first of the narrowing exceptions is the exception for transfers constituting a “substantially contemporaneous exchange.”⁷⁴ This provision recognizes the possibility that parties intending to engage in a simultaneous transaction may inadvertently introduce some delay between the delivery of goods and payment. For example, the debtor may elect to purchase goods from a local vendor, intending to pay for those goods the same day. He may load the goods into his truck, and then write a check to the vendor representing payment. The vendor will accept the check and cash it the next morning.⁷⁵ Although both parties intended payment to be rendered simultaneously to receipt of the goods, there may be a delay of some hours during which, it can be argued, a debt was owed to the vendor on account of the previous delivery of goods. Under preference policy, to the extent this delay was not intended to establish a line of credit and is limited in time, it is not made on account of an antecedent debt.⁷⁶ This is because preference policy is concerned with maintaining equality among creditors, not

71. 11 U.S.C. § 547(f).

72. See *Savage & Assocs. v. Mandl (In re Teligent Inc.)*, 380 B.R. 324, 339 (Bankr. S.D.N.Y. 2008); Countryman, *supra* note 36, at 736–37.

73. See TABB, *supra* note 23, at 486. Other avoidance powers include a trustee’s “strong arm” powers, to act as a lien creditor, *see* 11 U.S.C. § 544, the ability to avoid the fixing of a statutory lien, 11 U.S.C. § 545, the ability to avoid fraudulent transfers, 11 U.S.C. § 548, and the ability to avoid setoff during what is effectively the preference period, 11 U.S.C. § 553.

74. See 11 U.S.C. § 547(c)(1).

75. The legislative history suggests that this exception was written with bank checks in mind. See S. REP. No. 95-989, at 88 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5874.

76. See 11 U.S.C. § 547(b)(2).

unwinding business transactions with the debtor.⁷⁷ If the debtor does not intend for the transferee to become a creditor,⁷⁸ the transferee has no intention of extending credit,⁷⁹ and the exchange itself was in fact substantially contemporaneous,⁸⁰ then preference policy has no interest in that transfer.⁸¹

b. Purchase Money Security Interest

The second narrowing exception also deals with the concept of a transfer on account of an antecedent debt. Preference law preserves the creation of a valid purchase money security interest from preference liability,⁸² when the loan was given and in fact used by the debtor to acquire new property and the security interest was properly perfected within 30 days of the debtor receiving possession.⁸³ Understanding this exception requires understanding the different treatment of secured and unsecured creditors in bankruptcy. Bankruptcy policy has long recognized the priority treatment of creditors who have obtained a security interest in collateral. The general admonition that similarly situated creditors should be treated similarly⁸⁴ in bankruptcy recognizes dissimilarity between secured and unsecured creditors, and accordingly allows secured creditors particular benefits associated with their security interest. Properly secured and perfected creditors are not subject to the rules regarding pro rata distribution that bind unsecured creditors.⁸⁵ Instead, they retain their security interest through the bankruptcy.⁸⁶ In addition, a secured creditor may be entitled to a lifting of the automatic stay⁸⁷ or to interim payments before final distribution of an asset to preserve its interest in that asset.⁸⁸

To receive the benefits of a security interest in bankruptcy, however, a secured creditor must adhere to all relevant requirements of attachment and

77. See Broome, *supra* note 3, at 114.

78. 11 U.S.C. § 547(c)(1)(A).

79. *Id.*

80. *Id.* § 547(c)(1)(B).

81. This exception may trace its roots to observation of the 1973 Report that the Act at that time provided no guidance to when a debt became "antecedent," observing that "even a delay of a few minutes may result in a debt being antecedent." REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, H.R. DOC. NO. 93-137, pt. 1, at 205 (1973).

82. Generally speaking, a purchase money security interest (PMSI) is a security interest taken or retained by the seller of collateral to secure the collateral's purchase price. See U.C.C. § 9-103(b) (2013).

83. 11 U.S.C. § 547(c)(3).

84. See *supra* note 35.

85. See 11 U.S.C. § 506(a).

86. See *Dewsnup v. Timm*, 502 U.S. 410, 418 (1992); *Long v. Bullard*, 117 U.S. 617, 619-21, (1886).

87. See 11 U.S.C. § 362(d).

88. See *id.* § 361 (providing three methods of adequate protection); *Rogers*, *supra* note 24, at 977-78.

perfection of that interest. Otherwise, the trustee may avoid the creditor's interest in the collateral by virtue of the trustee's strong arm powers,⁸⁹ and the secured creditor will be treated as if it were unsecured. In other words, a creditor must have fully transformed under the law from being similarly situated to other unsecured creditors (who must rely on normal processes of execution and judgment for satisfaction in case of default), to being similarly situated to other secured creditors (with full rights of repossession, foreclosure, and priority). In addition, if the debtor grants an unsecured creditor a security interest such that the creditor becomes a secured creditor within the preference period, that grant can be avoided.⁹⁰ The advantages conferred by a change in status from an unsecured creditor to a secured creditor are recognized as a "transfer"⁹¹ that improves a creditor's position vis-à-vis other similarly situated creditors, and if those advantages are conferred on behalf of an antecedent debt,⁹² they are clearly preferential.

General concerns of preferring one (unsecured) creditor over another for the purposes of equal distribution do not apply in cases where a security interest is granted at the time the debtor receives new value from the creditor for the purpose of acquiring the collateral.⁹³ This is a narrowing of the preference rule rather than a true exception, under the theory that a creditor who gives value to become secured in collateral has never actually made a transition from an unsecured creditor to a secured creditor, representing an improvement in position. Instead, the creditor has, in theory, always been secured,⁹⁴ based on both parties' intent and their actual conduct, which undermines the concept that the attachment of the security interest constituted a transfer on account of an "antecedent" debt, and the concept that the creditor was "preferred" as a consequence of the attachment.⁹⁵

c. *Floating Lien*

The third narrowing exception deals with the definition of "transfer" in the context of a security agreement in inventory, receivables, or their

89. See 11 U.S.C. § 544.

90. *Id.* § 547(b).

91. *Id.* § 101(54)(A).

92. *Id.* § 547(b).

93. *Id.* § 547(c)(3).

94. This assumes that the creditor successfully perfects its lien within the applicable time period. If not, the transaction is subject to avoidance by the trustee pursuant to 11 U.S.C. § 544 and/or § 547.

95. See REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, H.R. DOC. NO. 93-137, pt. 1, at 207-08 (recommending the establishment an exception for so-called "enabling loans" where the acquisition of the debtor's property arises later in time than the advance of the loan, so that the transfer of a security interest is technically for an antecedent debt). There is also an argument to be made for the PMSI exception from the perspective of deterrence. Presumably, extension of the loan enabled the debtor to obtain the collateral, thereby increasing the value of the estate.

proceeds,⁹⁶ commonly referred to as a "floating lien." The exception defines transfer more narrowly to include only transactions that cumulatively create a net improvement of position for the creditor during the course of the preference period.⁹⁷ This narrowing may be intended to simplify calculating a preference in such situations as well as to avoid the improvement of a particular creditor's situation.⁹⁸ The rule also promotes the similar treatment of creditors with a security interest in inventory or accounts receivables compared to creditors that take security interests in other property.

Generally speaking, the appreciation of collateral during the preference period is not a preferential transfer, even if all other elements have been met.⁹⁹ This is because general appreciation by virtue of market forces is not recognized as a "transfer" under preference law.¹⁰⁰ However, the value of inventory or accounts receivables will change over time as a consequence of additions and reductions in the normal course of business, rather than simple appreciation. For example, companies may invest in inventory during a particular season, or increase sales and put off collection such that accounts receivables will swell. To the extent that creditors with an interest in inventory or receivables are undersecured at the beginning of the preference period, and therefore would receive more on account of an increase in inventory or receivables than they would otherwise in chapter 7,¹⁰¹ the increase represents a preference to the creditor that may be avoided.

However, the definition of avoidable transfer stated in the Code, without the narrowing exception, could include those transactions associated with normal turnover in inventory and accounts receivables. Unlike an interest in real estate or equipment, for example, an interest in inventory is presumed to involve near-constant turnover. The pieces of inventory in which a creditor is

96. 11 U.S.C. § 547(c)(5).

97. See TABB, *supra* note 23, at 551.

98. H. REP. NO. 95-595, at 214-16 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6176 (indicating that the rule is intended "to avoid complicated and expensive litigation by focusing the judicial inquiry on the situation as it existed on the two dates chosen as measuring points").

99. For example, suppose Creditor A has a security interest in the debtor's equipment, which is worth \$400,000 at the beginning of the preference period, but swells in value to \$800,000 by the end of the preference period, the time of the debtor's bankruptcy filing. Suppose further that Creditor A's claim against the debtor was \$600,000 at all relevant times, and that the debtor's estate will not pay its unsecured creditors in full. Had it not been for the appreciation in the equipment's value, Creditor A would have received \$400,000 for its security interest and a pro rata distribution for the remaining \$200,000. Accordingly, the appreciation has made Creditor A better off than it would have been without chapter 7. See 11 U.S.C. § 547(b)(5). Despite this, the equipment's appreciation in value is not considered a "transfer" recognized under preference law; accordingly the trustee cannot avoid Creditor A's interest in the equipment.

100. See, e.g., *Fairchild v. Leb. Prod. Credit Ass'n*, 31 B.R. 789, 794 (Bankr. S.D. Ohio 1983); *In re Nivens*, 22 B.R. 287, 293 (Bankr. N.D. Tex. 1982). *But see* Carlson, *supra* note 41, at 241 (noting alternative positions regarding the increase in value of collateral over time).

101. See *supra* note 96.

secured at the beginning of the preference period are highly unlikely to remain in a debtor's inventory by the end of the preference period. Instead, they will have been replaced with new inventory as the old inventory was sold. Without this narrowing definition, preference law would treat the attachment of a security interest in each new piece of inventory obtained during the preference period as an avoidable transfer, and an improvement to the creditor's position made on account of an antecedent debt.

The Bankruptcy Code does not allow a trustee to avoid transfers that create a perfected security interest in inventory or receivables—except to the extent that the transfers in the aggregate made the creditor better off at the end of the preference period than it was at the beginning of the preference period.¹⁰² This is the “two-point net improvement test”:¹⁰³ the Bankruptcy Code looks at the creditor's position at the beginning of the relevant preference period,¹⁰⁴ and then compares it with the creditor's position at the end of the preference period. To the extent that a creditor has less unsecured debt at the end of the preference period than it had at the beginning of the preference period,¹⁰⁵ that amount of improvement may be avoided by the trustee.

d. Transfers for the Benefit of an Insider

The final narrowing exception is in a separate subsection, and addresses the preference period, particularly for transfers to insiders.¹⁰⁶ In the Bankruptcy Code, the general preference period is 90 days prior to the date of the bankruptcy petition.¹⁰⁷ But where the creditor/transferee is an insider, the preference period is expanded to one year.¹⁰⁸ Insider status is given to relatives of individual debtors, directors, officers, or partners of corporate debtors, and those with similar connections.¹⁰⁹ The Code distinguishes insiders from general unsecured creditors, much as secured creditors are distinguished, except that insiders are targeted for less favorable treatment, not more. Likewise, insiders or equity holders of a corporate debtor are generally placed further down in the order of repayment,¹¹⁰ reflecting both

102. 11 U.S.C. § 547(c)(5).

103. See TABB, *supra* note 23, at 551.

104. See 11 U.S.C. § 547(c)(5)(A) (providing either 90 days for general creditors or one year for insiders).

105. Secured creditors receive payment in full in bankruptcy for the portion of their claims that is secured by collateral. To the extent their claims exceed the value of the collateral, the remaining debt is treated the same as all other unsecured debt, and is paid out according to the same pro rata distribution. See *id.* § 506(a)(1).

106. *Id.* § 547(i).

107. *Id.* § 547(b)(4)(A).

108. *Id.* § 547(b)(4)(B).

109. See *id.* § 101(31).

110. See *id.* §§ 726(a), 1129(b).

the risky nature of their investment and the attitude that those who control the company should bear the greatest responsibility for its failure.¹¹¹

The narrowing exception related to the insider time frame simply clarifies the target of transfer avoidance. Because avoidable transfers may be made “to or for the benefit of a creditor,”¹¹² it is possible for a transfer to a non-insider to be made for the benefit of an insider. Such a transfer would be avoidable under preference law. The exception merely clarifies that it is avoided only with respect to the insider, and not with respect to the non-insider transferee, reflecting the different, more stringent treatment given insiders under preference law than that given general creditors.

2. True Exceptions

In contrast to these narrowing exceptions, which clarify or refine the equal distribution goal of preference law, there are also exceptions that further distinct policies. These exceptions aim to protect specific types of creditors and to encourage behavior among creditors that will assist, or at least not undermine, a struggling debtor.

a. Ordinary Course

The first of these “true” exceptions is the “ordinary course” exception,¹¹³ which is responsible for an extraordinary amount of the litigation surrounding preference law. Nearly three-quarters of all preference cases involve an ordinary course defense,¹¹⁴ and such a defense is often sufficient to at least take the case past summary judgment.¹¹⁵ More than the other true exceptions, and perhaps much more based on the litigation impact, this exception undermines the stated purpose of preference law in pursuit of an alternative goal.

Under this exception, the trustee cannot avoid a transfer to the extent that the debt was incurred “in the ordinary course of business or financial affairs of the debtor,” and repaid “in the ordinary course of business” or

111. See John J. Slain & Homer Kripke, *The Interface Between Securities Regulation and Bankruptcy—Allocating the Risk of Illegal Securities Issuance Between Securityholders and the Issuer's Creditors*, 48 N.Y.U. L. REV. 261, 263 (1973) (noting “the normal expectation that equity investment and junior debt will bear the first losses of the enterprise”).

112. 11 U.S.C. § 547(b)(1).

113. See *id.* § 547(c)(2).

114. *Amer. Bank. Inst. Task Force on Preferences*, ABI PREFERENCE SURVEY (May 1997), <http://www.abiworld.org/legis/reform/preferencesurvey.html>; see also Joseph M. Mulvihill, *The Ordinary Course of Business Defense in Bankruptcy Preference Actions: Methods of Comparison*, 38 DEL. J. CORP. L. 637, 638 (2013) (noting that the ordinary course of business defense is one of the most inconsistent and unsettled areas of preference litigation); Tabb, *supra* note 26, at 1032 (“The main issue in almost every preference case involving trade creditors is the application of section 547(c)(2).”).

115. TABB, *supra* note 23, at 524.

“according to ordinary business terms.”¹¹⁶ The breadth of the exception, particularly on what constitutes “ordinary,” encourages its use as a defense in preference actions.¹¹⁷ Interpreted broadly enough, it threatens to swallow the rule of preferences.¹¹⁸ The exception’s boundaries have proved notoriously difficult to define.¹¹⁹

The stated purpose for the ordinary course exception was “to leave undisturbed normal financial relations,”¹²⁰ so as not to force a debtor into bankruptcy prematurely. The advocates of this exception explained the rationale behind its inclusion as if the policy behind preference actions was to encourage the financial survival of the debtor pre-bankruptcy, observing that “it does not detract from the general policy of the preference section to discourage unusual action by either the debtor or his creditors during the debtor’s slide into bankruptcy.”¹²¹ This perspective fails to recognize the stated underlying policy of preference law, equal distribution among creditors, and instead introduces a separate, if also laudable goal: encouraging a pre-bankruptcy debtor’s ongoing survival, both for its own sake and to maximize the creditor payout. This conflict explains the difficulty in preference law of attempting to satisfy what is presumed to be a unified, or at least a joint policy, but actually reflects competing goals.¹²²

116. 11 U.S.C. § 547(c)(2).

117. TABB, *supra* note 23, at 524 (“The ordinary course exception breeds and feeds litigation.”); Katz et al., *supra* note 3, at 11 (“The need to retain conflicting experts on ‘ordinary course’ defenses is an expense for both sides to the dispute. These costs are difficult, if not impossible, to recover.”).

118. See Margolis, *supra* note 46, at 592 (observing that the 2005 amendment provide that only exceptionally idiosyncratic dealings will fall outside the broad range of transactions under the ordinary course exception); Tabb, *supra* note 26, at 986 (noting the ordinary course exceptions “swallows up any realistic supposition that equality matters”).

119. See, e.g., Lovett v. St. Johnsbury Trucking, 931 F.2d 494, 497–98 (8th Cir. 1991) (“[T]here is no precise legal test which can be applied’ in determining whether payments by the debtor during the 90-day period were ‘made in the ordinary course of business’; rather, th[e] court must engage in a ‘peculiarly factual analysis.’” (alternation in original) (quoting *In re Fulghum Constr. Corp.*, 872 F.2d 739, 743 (6th Cir. 1989)); NEIL STEINKAMP & JAKE REED, UNDERSTANDING ORDINARY: A PRIMER ON FINANCIAL AND ECONOMIC CONSIDERATIONS FOR THE ORDINARY COURSE DEFENSES TO BANKRUPTCY PREFERENCE ACTIONS 18–19 (2013) (listing various comments from recent court rulings regarding the definition of “ordinary business terms”).

120. S. REP. NO. 95-989, at 88 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5874; H.R. REP. NO. 95-595, at 373 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6329.

121. *Id.*

122. C. Robert Morris, *Bankrupt Fantasy: The Site of Missing Words and the Order of Illusory Events*, 45 ARK. L. REV. 265, 277 (1992) (“Preference law has always had difficulty distinguishing between preferential transactions which should be avoided and those which should be permitted to stand. In theory, transfers induced by the expectation or fear of an imminent bankruptcy should be avoided; but transfers in the ordinary course of business should stand, even though the debtor was insolvent and the creditor received more than it would have in an ensuing bankruptcy.”).

b. *New Value*

The second of the true exceptions is the new value exception,¹²³ which provides that a creditor's provision of subsequent and unsecured new value (additional loans, services, credit, or release of property)¹²⁴ forgives a prior preferential transfer, up to the amount of the new value. The timing here is essential—the creditor must have given new value after such transfer, and the creditor cannot have been reimbursed on account of such new value.¹²⁵ The creditor cannot argue, for example, that the court should look to the “net result” of all transfers during the preference period between the debtor and creditor.¹²⁶ The purpose of the new value exception is not to determine whether or not the creditor has provided credit, goods, or services in exchange for the debtor's transfer—it is presumed that there was an antecedent debt justifying the receipt of the transfer. Instead, the creditor must show that the debtor's estate was subsequently replenished by the creditor following the avoidable transfer. Under the terms of the exception, the creditor may keep the portion of the avoidable transfer for which it has subsequently provided new value.¹²⁷

The justification for the new value exception is similar to that underlying the ordinary course exception,¹²⁸ and comprises the flip side of the deterrence policy associated with preference law. More than simply deterring a race to the courthouse, both exceptions seek to encourage ongoing commercial relations between creditors and debtors. Beyond discouraging creditors from insisting on payment when the debtor appears to be flagging, the new value exception, in particular, seeks to reward creditors who extend

123. See 11 U.S.C. § 547(c)(4) (2012).

124. “New value” is defined in 11 U.S.C. § 547(a)(2).

125. 11 U.S.C. § 547(c)(4)(B).

126. See TABB, *supra* note 23, at 544; Harris P. Quinn, *The Subsequent New Value Exception Under Section 547 (c)(4) of the Bankruptcy Code—Judicial Gloss Is Creditors' Loss*, 24 MEMPHIS ST. U. L. REV. 667, 670–75 (1994).

127. A comparison of factual examples may be useful here. Suppose the preference period runs from January 1 to March 31. On January 1, Creditor is owed \$400,000 by the Debtor. Debtor transfers \$100,000 to Creditor on February 1. On March 1, the Creditor supplies Debtor with \$80,000 of new value, in the form of additional credit. Under preference law, the \$100,000 transfer from the Debtor to the Creditor is avoidable. However, under the new value exception, \$80,000 of that transfer will not be avoided on account of the Creditor's extension of additional credit. Instead, the Creditor will be liable to the estate for only \$20,000.

In contrast, assume that under the same factual scenario, with creditor owed the underlying debt of \$400,000 as of January 1, Creditor extends an additional \$80,000 of credit on February 1. On March 1, Debtor transfers \$100,000 to Creditor. In this situation, Creditor will be liable to the estate for the entire \$100,000, with no regard for Creditor's previous extension of additional credit. Although the Creditor extended the same dollar amount of “new value” as in the first scenario, it was not extended subsequent to the avoidable transfer, and therefore falls outside of the new value exception.

128. See *supra* notes 120–21 and accompanying text.

the debtor new credit in the days leading up to bankruptcy.¹²⁹ The new value exception acts as a form of absolution for creditors who have received a preferential transfer, so long as the value was given after the transfer. Like the ordinary course exception, it identifies “good” creditors as those who obtain their preference in the course of assisting the debtor’s business, as opposed to “bad” creditors who obtain a preference ostensibly by overreaching. In this way, the exception undermines the notion that preference law is one of strict liability, unaffected by notions of fairness or creditor worthiness, and instead, recognizes a difference in creditor position based on the preferred creditor’s past generosity, or lack thereof, to the debtor.¹³⁰

c. Statutory Lien

The third of the true exceptions, like many that follow, reflects a distinct policy preference unrelated to the policy of equal distribution or the goal of deterring creditor overreach. This exception protects statutory liens from preference liability to the extent they are not avoidable by virtue of a trustee’s power in a separate subsection.¹³¹ Although Congress elected to override some statutory liens by virtue of the bankruptcy power,¹³² it leaves others untouched, preserved both from the trustee’s ability to avoid statutory liens generally and from preference law. This is a straight-forward policy decision: statutory liens that do not fall under the categories Congress has defined take priority over the bankruptcy policies that would have avoided them.¹³³

129. See REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, H.R. DOC. NO. 93-137, pt. I, at 210 (“This provision is designed to promote fairness to preferred creditors and also to encourage new credit.”).

130. The new value exception can trace its roots to a period in which preference law was not one of strict liability. See Bankruptcy Act of 1898, ch. 541, § 60(c), 30 Stat. 544 (repealed 1978) (permitting a preferred creditor who subsequently in good faith gives the debtor further credit to set off the amount of new credit against the otherwise recoverable preference). Recent developments in the Third Circuit have raised a debate as to the purpose of the new value exception, particularly whether the court was correct in determining that the exception embodies the goal of deterrence over equality. See Joseph L. Steinfeld, Jr. & Kara E. Casteel, *Critical-Vendor Creditors May Now Double-Dip on New Value*, AM. BANKR. INST. J., March 2014, at 48 (noting that the court’s analysis in *Friedman’s Liquidating Trust v. Roth Staffing Cos. (In re Friedman’s, Inc.)*, 738 F.3d 547 (3d Cir. 2013), was incorrect in ignoring the policy of equal distribution among creditors and instead treating one similarly-situated creditor better than others); Jeffrey R. Waxman, *Petition Date Fixes Amount of Defendant’s Subsequent New Value*, AM. BANKR. INST. J., March 2014, at 46 (noting that *In re Friedman’s Inc.* reached the correct result in promoting the debtor’s ability to reorganize on a going-concern basis).

131. See 11 U.S.C. § 547(c)(6) (2012).

132. See *id.* § 545. Avoidable liens include those that first become effective by virtue of a bankruptcy filing or condition of insolvency, as well as those that are unenforceable against a bona fide purchaser. Statutory liens for rent are also avoidable. *Id.*

133. Examples of unavoidable statutory liens include a producer’s liens on partially processed grapes, *In re Loretto Winery Ltd.*, 898 F.2d 715, 718–19, 724 (9th Cir. 1990), farmers’ liens on grain deposited in a grain elevator, *In re Merchants Grain, Inc.*, 184 B.R. 52, 58 (S.D. Ind. 1995), *aff’d sub nom. Matter of Merchants Grain, Inc.*, 93 F.3d 1347 (7th Cir. 1996), and wage

d. *Domestic Support Obligations*¹³⁴

Consistent with other sections of the Bankruptcy Code that prioritize payment of domestic support obligations¹³⁵ and make them nondischargeable in bankruptcy,¹³⁶ transfers constituting a bona fide payment of a domestic support obligation debt are not avoidable in bankruptcy.¹³⁷ The rationale behind this exception is not related to the policy of equal distribution or the goals of deterrence policy. Instead, it is likely motivated by the difficult situation faced by domestic support recipients, a desire to assist such recipients to the extent feasible, and a hearty distaste for clawing back funds from women and children for the sake of the bankruptcy distribution.¹³⁸

e. *Monetary Floors*

The Bankruptcy Code has also established monetary floors on the amount of a transfer that the trustee may pursue in a preference proceeding. In consumer cases, a trustee may not avoid a transfer of less than \$600.¹³⁹ In all other cases, a transfer must have an aggregate value of at least \$6225.¹⁴⁰ These amounts could be said to clarify the definition of “transfer,” by introducing a monetary floor. They also introduce a distinct policy consideration. Arguably, this exception is intended to reduce costs to the estate in cases where the amounts are too trifling to justify the effort, promoting a policy of cost-effectiveness in bankruptcy administration.¹⁴¹ More likely, however, given the discretion inherent in a trustee’s decision to pursue a preference claim¹⁴² and the presumption that the trustee will perform a cost-

earners’ liens, *In re Napco Graphic Arts, Inc.*, 51 B.R. 757, 764 (Bankr. E.D. Wis. 1985), *aff’d in part, rev’d in part sub nom. In re Napco Graphic Arts, Inc.*, 83 B.R. 558 (E.D. Wis. 1988).

134. Note that this exception is unlikely to arise with any frequency in the business context. It is included here for the sake of comprehensive treatment regarding the preference exceptions.

135. 11 U.S.C. § 507(a).

136. *Id.* § 523(a)(5).

137. *Id.* § 547(c)(7).

138. Through a combination of provisions, the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (“BAPCPA”), Pub. L. No. 109-8, 119 Stat. 23, generally sought to benefit the recipients of domestic support obligations (“DSOs”). For example, BAPCPA tightened restrictions on the discharge of DSOs, raised the priority of DSOs, and increased related exceptions to the automatic stay. See Roger M. Baron & Cassidy M. Stalley, *The Top Ten Things the Family Law Attorney Should Know About the Recent Changes in Bankruptcy Law*, J. MO. B., May–June 2011, at 170, 170–72. This exception may be unnecessary in light of the fact that DSOs receive the highest priority of all claims, aside from the chapter 7 trustee’s administrative expenses in recovering funds. See 11 U.S.C. § 507(a)(1). Accordingly, it seems unlikely that many, if any, transfers to a DSO will satisfy the final prong of preference law, and that the transfer has made the recipient better off than they would have been under a chapter 7 distribution. See *id.* § 547(b)(5).

139. 11 U.S.C. § 547(c)(8). Dollar amounts will change on April 1, 2016.

140. *Id.* § 547(c)(9). Dollar amounts will change on April 1, 2016.

141. See REPORT OF THE COMM’N ON THE BANKRUPTCY LAWS OF THE UNITED STATES, H.R. DOC. NO. 93-137, pt. 1 at 206 (1973).

142. See *infra* note 172 and accompanying text.

benefit analysis,¹⁴³ the floor is intended to protect smaller creditors from a trustee's avoidance action. It may be presumed that those who have received smaller amounts from the debtor are themselves smaller creditors. Smaller creditors will likely suffer more from an avoidance action since they are presumably less able to sustain losses. They are also presumably less capable of asserting a defense against such a claim, particularly in a remote venue, which is common in bankruptcy proceedings.¹⁴⁴ Again, these concerns do not further equal distribution among creditors and—assuming, as is true generally, that creditors are not distinguished according to their size or the size of their claims—may actually undermine it.¹⁴⁵

*f. Nonprofit Budget and Credit Counseling*¹⁴⁶

Congress added the final true exception to the Code as part of the 2005 Amendments,¹⁴⁷ which generally sought to encourage repayment of consumer debt, whether in or out of bankruptcy.¹⁴⁸ In keeping with this underlying policy goal, the exception indicates that a trustee may not avoid transfers made as part of a payment schedule “created by an approved nonprofit budget and credit counseling agency.”¹⁴⁹ Through this exception, Congress sought to encourage these types of repayment plans outside the bankruptcy system.¹⁵⁰ The fear was that creditors might not accept such payments if they would then possibly be subject to a preference action, should the payment plan fail to keep the debtor out of bankruptcy. This exception therefore prefers payments made under such a plan, undermining a strict equality approach.

143. See, e.g., *In re Arnold*, 176 B.R. 13, 15 (Bankr. E.D. Tex. 1995); see also *In re Riverside-Linden Inv. Co.*, 925 F.2d 320, 322 (9th Cir. 1991).

144. Margolis, *supra* note 46, at 591 (noting that normal standards for minimal contacts do not apply in bankruptcy court).

145. Note that in business reorganizations, creditors with smaller claims may be treated differently than other creditors by virtue of being classified separately for administrative convenience. 11 U.S.C. § 1122(b). This only reinforces the different approaches exercised in a chapter 7 liquidation versus a chapter 11 reorganization. See *infra* notes 162–72 and accompanying text.

146. This exception is also unlikely to arise with any frequency in the business bankruptcy context. See *infra* Part III (discussing business bankruptcy filings in chapters 7 and 11).

147. See Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, 119 Stat. 23 (2005).

148. See Susan Jensen, *A Legislative History of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005*, 79 AM. BANKR. L.J. 485, 495 (2005) (referencing early concerns that the bankruptcy system made it too easy for individuals to discharge debts rather than repay them); Press Release, White House Press Office, President Signs Bankruptcy Abuse Prevention, Consumer Protection Act (Apr. 20, 2005), available at <http://georgewbush-whitehouse.archives.gov/news/releases/2005/04/20050420-5.html>.

149. 11 U.S.C. § 547(h).

150. The preference safe harbor for such repayment plans was part of the BAPCPA section titled “Promotion of Alternative Dispute Resolution.” See BAPCPA § 201.

C. ENFORCEMENT ACROSS CHAPTERS

A final point necessary to understand preference law is the way it works across the different chapters in bankruptcy. Generally speaking, preference actions may arise in either the liquidation context, under chapter 7 proceedings, or in reorganizations under chapter 11.¹⁵¹ Currently, the provisions granting a trustee the authority to pursue preferences are applicable across all chapters of bankruptcy, but arise with precipitously reduced frequency in chapters aside from 7 or 11. For example, preference actions may also apply to municipal bankruptcies in chapter 9,¹⁵² and to the reorganization of family farmers and fishermen in chapter 12.¹⁵³ Because of the infrequency of these cases in general, however,¹⁵⁴ this Article does not address policy concerns specific to them. Preference actions cannot be brought in international bankruptcies under chapter 15,¹⁵⁵ and the authority to bring preference actions in chapter 13, which permits the reorganization of individual wage earners,¹⁵⁶ is uncertain, for reasons explained below.

A chapter 13 trustee distributes money pursuant to the chapter 13 plan proposed by the debtor, and generally oversees the debtor's financial affairs.¹⁵⁷ The trustee does not take control of the debtor's estate.¹⁵⁸ Because the statute makes no express provision permitting or prohibiting a chapter 13 trustee from exercising a trustee's avoidance powers, courts are split on whether the chapter 13 trustee or the chapter 13 debtor, or both, have the responsibility and the standing to bring a preference action.¹⁵⁹ It may be that

151. Chapter 11 is typically used in the context of business reorganizations; however, it is possible for individuals to file for chapter 11. *See* 11 U.S.C. § 109(d) (providing that a person who may be a debtor under chapter 7 "may be a debtor under chapter 11"). Because individual chapter 11 cases make up a substantially small portion of the overall filings, *see* U.S. BANKR. COURTS, BUSINESS AND NONBUSINESS CASES COMMENCED, BY CHAPTER OF THE BANKRUPTCY CODE, DURING THE 12-MONTH PERIOD ENDING DECEMBER 31, 2013, *available at* http://www.uscourts.gov/uscourts/Statistics/BankruptcyStatistics/BankruptcyFilings/2013/1213_f2.pdf (identifying a total of 8980 chapter 11 cases, of which 1320 constituted nonbusiness filings), this Article generally assumes a chapter 11 policy aimed at business reorganizations.

152. *See* 11 U.S.C. § 926 (referencing the authority to bring avoidance actions).

153. *See id.* § 1203 (giving a debtor in possession all the powers of a trustee serving under chapter 11).

154. *See* U.S. BANKR. COURTS, *supra* note 151 (identifying a total of nine filings in chapter 9 and 395 filings in chapter 12 during 2013, out of a total of 1,071,932 filings overall).

155. *See* 11 U.S.C. § 1521(a)(7).

156. *See id.* § 109(e) ("Only an individual with regular income . . . may be a debtor under chapter 13 of this title.").

157. *Id.* §§ 704(a), 1302.

158. *See id.* § 1302; TABB, *supra* note 23, at 88.

159. *In re Binghi*, 299 B.R. 300, 302 (Bankr. S.D.N.Y. 2003) ("The plain language of Section 1303 is quite explicit and does not include the avoidance powers under Chapter 5 of the Code. . . . Not surprisingly, courts are split on this issue."). The majority of courts have concluded that, in absence of explicit statutory authority, chapter 13 debtors do not have standing to bring an avoidance action. *See Knapper v. Bankers Trust Co. (In re Knapper)*, 407 F.3d 573, 583 (3d Cir. 2005) (finding that a chapter 13 debtor cannot invoke trustee's strong-arm powers under

preference actions are inappropriate in a chapter 13 in any scenario, because creditors in chapter 13 are entitled to exclusively post-petition income,¹⁶⁰ and preferential transfers are by definition pre-petition assets.¹⁶¹ Due to the uncertainty regarding preference actions in chapter 13, and the distinct policy concerns raised in individual bankruptcies, it is logical to exclude these cases, and policy concerns associated with chapter 13, from analysis.

Accordingly, this Subpart will limit its discussion of enforcement to business bankruptcy filings in chapters 7 and 11. In a chapter 7 liquidation, a preference action would be brought by the chapter 7 trustee, acting on behalf of the bankruptcy estate. The chapter 7 trustee, like all bankruptcy trustees, is appointed by the United States Trustee (“UST”),¹⁶² an office of the Department of Justice that serves to carry out the administration of bankruptcy cases.¹⁶³ The chapter 7 trustee has the duty to collect the assets of the estate, liquidate those assets, object to claims as needed, and file a final report and accounting explaining how the liquidated assets will be distributed.¹⁶⁴ As part of these collection efforts, the chapter 7 trustee has the authority to avoid preferential transfers.¹⁶⁵ The chapter 7 trustee also has a

§ 544(b)(1)); *Stangel v. United States (In re Stangel)*, 219 F.3d 498, 501 (5th Cir. 2000) (finding chapter 13 debtors lack standing to bring avoidance action under § 545); *LaBarge v. Benda (In re Merrifield)*, 214 B.R. 362, 364–65 (B.A.P. 8th Cir. 1997) (the statutory language of § 548 expressly confers avoidance powers exclusively on the trustee); *In re Binghi*, 299 B.R. at 301–02 (holding that the plain language of § 1303, which details the “Rights and powers of debtor,” does not include avoidance powers). However, a significant minority has concluded the opposite. *See also Houston v. Eiler (In re Cohen)*, 305 B.R. 886, 889–900 (B.A.P. 9th Cir. 2004); *Realty Portfolio, Inc. v. Hamilton (In re Hamilton)*, 125 F.3d 292, 296 (5th Cir. 1997) (noting the issue, and listing courts on either side of the issue, but declining to address the issue and reversing on other grounds); *United States v. Dewes*, 315 B.R. 834, 836–37 (N.D. Ind. 2004) (concluding that the bankruptcy court’s ruling granting a debtor standing to avoid a preference was not clearly erroneous); *Russo v. Ciavarella (In re Ciavarella)*, 28 B.R. 823, 825–26 (Bankr. S.D.N.Y. 1983) (ruling that a chapter 13 trustee cannot bring a preference action over the objections of a chapter 13 debtor).

160. *See* 11 U.S.C. § 1322(a).

161. There is the possibility that the existence of a preferential transfer could impact the best interests test. *See id.* § 1325(a)(4) (requiring creditors receive more under a chapter 13 plan than they would have received in a chapter 7 liquidation). If a transfer would have been avoided in chapter 7, this could require a greater payout in chapter 13). *Id.*; *see also In re Ciavarella*, 28 B.R. at 826. However, a preference would not need to be actually recovered; the amount could easily be estimated by the court for purposes of the Best Interests Test. Actual recovery would provide no benefit for creditors. For additional discussion, *see generally* Al Teel, *Why Are Chapter 13 Debtors Still “Standing” in Their Battle for Trustee’s Avoidance Powers?: A Call to Resolve the Current Circuit Split*, 43 CUMB. L. REV. 311, 329–39 (2013).

162. The UST is commonly referred to as the “watchdog” of the bankruptcy process. *See* Anne E. Wells, *Not in My House: Combating Unethical Mortgage Lender Practices and Related Attorney Misconduct in the Bankruptcy Courts*, 32 CAL. BANKR. J. 483, 507–08 (2013).

163. *See* TABB, *supra* note 23, at 89–90; Michael D. Sousa, *A Delicate Balancing Act: Satisfying the Fourth Amendment While Protecting the Bankruptcy System from Debtor Fraud*, 28 YALE J. ON REG. 367, 376 (2011).

164. *See* TABB, *supra* note 23, at 87.

165. 11 U.S.C. § 547.

fiduciary duty to administer the estate expeditiously and to consider the best interests of the parties.¹⁶⁶ The trustee is compensated in proportion to the money recovered on behalf of the estate.¹⁶⁷ As a consequence, the chapter 7 trustee's fiduciary duty and personal incentives generally align to encourage the pursuit and recapture of preferential transfers, as long as it would be in the best interests of the estate.

In a chapter 11, a trustee is not appointed unless cause is shown.¹⁶⁸ Such cause typically involves egregious misbehavior by existing management, such as fraud or embezzlement,¹⁶⁹ although cause may also be demonstrated by gross mismanagement, such as the failure to keep legal records.¹⁷⁰ Instead, chapter 11 estates are typically managed by the debtor, acting as debtor-in-possession ("DIP"). The DIP acts as the fiduciary representative of the bankruptcy estate, and exercises all of a trustee's duties, rights, and powers, except investigation and reporting of the debtor's misconduct.¹⁷¹ Accordingly, in a chapter 11, it is usually the debtor's responsibility, in its capacity as DIP, to initiate and pursue a preference action.¹⁷²

The decision to initiate a preference action is discretionary.¹⁷³ Although there are practical constraints on a trustee or a DIP's decision to bring an transfer avoidance action, discussed in greater detail below, there are no legal requirements detailing when a trustee *must* bring an action, only circumstances in which the trustee "*may not*" avoid a transaction in the presence of defenses.¹⁷⁴ Trustees and DIPs are presumed to take costs of an action into account,¹⁷⁵ in addition to other relevant factors. Trustees in chapter 7 are generally concerned with maximizing the estate for the benefit of creditors, and so they are conscious of a particular action's likely success in

166. *Id.* § 704(a)(1).

167. *See id.* § 326(a) (explaining that in a case under chapter 7, the court may compensate a trustee up to 25% of the first \$5,000, 10% on the next \$45,000, 5% on the next \$950,000, and 3% of all excess of moneys disbursed to creditors).

168. *Id.* § 1104(a)(1) ("[T]he court shall order the appointment of a trustee—(1) for cause, including fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor by current management, either before or after the commencement of the case, or similar cause, but not including the number of holders of securities of the debtor or the amount of assets or liabilities of the debtor.").

169. *See* TABB, *supra* note 23, at 1062.

170. Raymond T. Nimmer & Richard B. Feinberg, *Chapter 11 Business Governance: Fiduciary Duties, Business Judgment, Trustees and Exclusivity*, 6 BANKR. DEV. J. 1, 56–57 (1989).

171. *See* 11 U.S.C. § 1107(a).

172. Debtors in chapter 12, which facilitates the bankruptcy of family farmers or fisherman, *see id.* § 109(f), have similar authority to DIPs. *Id.* § 1203.

173. *See id.* § 547(b) ("[T]he trustee *may* avoid any transfer of an interest of the debtor . . .") (emphasis added). *But see infra* note 198.

174. 11 U.S.C. § 547(c) (emphasis added).

175. *See supra* note 16 and accompanying text.

relation to the costs imposed on the estate in pursuit of that action.¹⁷⁶ Such concerns are not directly associated with equality of distribution, and may undermine it, if equal treatment proves too costly to achieve. A DIP's decision is likely to be informed by a strategic analysis of how preference actions can most benefit the debtor, and by extension, the creditors of the estate.¹⁷⁷ This analysis is even less likely to include, and may be directly contrary to, considerations of equal treatment among creditors.¹⁷⁸

II. PART TWO: THE POLIC(IES) OF PREFERENTIAL TRANSFERS IN IMPLEMENTATION

This Part will analyze how preference law currently struggles to fulfill its intended policy goal of equal distribution. It will demonstrate how the goal of equal distribution conflicts with bankruptcy goals of maximizing the estate and promoting the debtor's ongoing survival in both the chapter 7 context and, to a much greater extent, in chapter 11. In both chapter 7 and chapter 11, equality of distribution is generally subservient to other policy goals, as reflected by the procedures of business liquidation or reorganization.

The policies of estate maximization and debtor survival also inform how preference law is implemented in both chapters. Those who enforce preference law rarely take actions motivated by a policy of equal distribution. Instead, they are more likely to be influenced by broader considerations of bankruptcy policy. For example, a chapter 7 trustee is more likely to be motivated to act in ways that will maximize creditor payout, and this motivation will continue to play a primary role in a decision whether or not to pursue preference actions. A chapter 11 DIP, on the other hand, is more likely to be motivated to act in ways that will promote the continuation of the business, and ensure a better financial position for the business once it emerges from bankruptcy. This thinking will also inform decisions regarding preferences.

A. *THE POLICY OF EQUAL DISTRIBUTION IN CHAPTER 7*

Chapter 7 trustees have a fiduciary duty by statute to "collect and reduce to money the property of the estate . . . and close such estate as expeditiously as is compatible with the best interests of parties in interests."¹⁷⁹ In fulfilling

176. See Nancy B. Rapoport, *Turning and Turning in the Widening Gyre: The Problem of Potential Conflicts of Interest in Bankruptcy*, 26 CONN. L. REV. 913, 933 (1994).

177. In recognition of the tendency towards acting in one's own self-interest, the Bankruptcy Code imposes fiduciary duties on the DIP that run to creditors of the estate, but these duties do not generally curtail the DIP's authority to act. See Steve H. Nickles, *Behavioral Effect of New Bankruptcy Law on Management and Lawyers: Collage of Recent Statutes and Cases Discouraging Chapter 11 Bankruptcy*, 59 ARK. L. REV. 329, 400-02 (2006); Scott F. Norberg, *Debtor Incentives, Agency Costs, and Voting Theory in Chapter 11*, 46 U. KAN. L. REV. 507, 526 (1998).

178. See *infra* notes 193-94.

179. 11 U.S.C. § 704(a)(1).

this duty, chapter 7 trustees generally have similar incentives to the creditors of the estate: to find the money quickly and efficiently, and get it distributed according to the requirements of the Bankruptcy Code. Chapter 7 trustees frequently must exercise business judgment in administering a bankruptcy estate, taking into account the costs and benefits of any particular action.¹⁸⁰ For example, a debtor's assets are often already encumbered by one or more security interests when the trustee collects them into the estate. It will be up to the trustee to determine whether sale of encumbered assets is in the best interests of the estate, based on the anticipated value the assets have and the amount of the underlying loan. In situations where sale of the asset is unlikely to result in a recovery for the estate, because the asset is worth very little, the costs of maintaining the assets are very high, or the asset is already fully encumbered, the trustee should abandon the property.¹⁸¹ The trustee makes that judgment,¹⁸² although other parties may request a court order of abandonment if they can establish that the asset is burdensome to the estate.¹⁸³

The chapter 7 trustee's judgment in the decision to pursue preference actions is also given deference.¹⁸⁴ From the perspective of maximizing the estate, it is vital to exercise judgment in deciding to pursue or "abandon" preference actions. The costs of pursuing a preference might be extensive or the delay in distributing the estate to creditors may undermine any overall benefit they would receive as a result.¹⁸⁵ Primary considerations for a chapter

180. This is generally true, although there may be instances where the cost benefit analysis for the particular case must be subjugated to the superior demands of protecting the system, as in the case of a particularly bad actor. For example, it may not be in the best interests of creditors to object to a debtor's discharge (if the debtor is likely to be judgment-proof for the foreseeable future), but the action may nevertheless be called for in light of the debtor's flagrant abuse of the system. *See id.* § 727(a) (listing reasons for which a debtor should be denied a discharge, including transfer or destruction of estate property, lying to the court, and refusing to obey lawful orders of the court); *see also In re Brook Mays Music Co.*, No. 06-32816, 2007 WL 4960375, at *1 (Bankr. N.D. Tex. Aug. 1, 2007) (noting relationship between exercise of avoidance power and fiduciary duty to the estate).

181. *See* 11 U.S.C. § 554; Joseph S. Maniscalco, Note, *At the Crossroads of Environmental Laws and the Bankruptcy Code: Abandonment and Trustee Personal Liability*, 23 HOFSTRA L. REV. 879, 894 (1995) ("Some commentators have argued that the clear language of § 544(a), coupled with the lack of legislative history seems to indicate only one result: 'the trustee's cost-benefit analysis should be the sole consideration in abandonment decisions.'" (citations omitted)).

182. *See In re Meyers*, 139 B.R. 858, 862 (Bankr. N.D. Ohio 1992).

183. 11 U.S.C. § 554(b).

184. *See id.* § 547(b); *see also Surf N Sun Apts., Inc. v. Dempsey*, 253 B.R. 490, 491 (M.D. Fla. 1999) (holding that only the trustee has standing to prosecute fraudulent transfer actions). *But see In re Racing Servs., Inc.*, 540 F.3d 892, 898 (8th Cir. 2008) (holding that "derivative standing is available to a creditor to pursue avoidance actions when a chapter 7 trustee . . . is unable or unwilling to do so" (internal quotation marks omitted)).

185. Case law further suggests that a chapter 7 trustee is prohibited from selling rights to a preference action, which might otherwise permit the chapter 7 trustee to recover funds by virtue of the preference action without expending the necessary costs for recover. *See In re Sapolin*

7 trustee faced with a possible preference action include the ease of establishing the underlying elements, particularly whether the presumption of insolvency will arise,¹⁸⁶ the availability of defenses, and the likelihood of collection, which may depend on the characteristics of the creditor-defendant.¹⁸⁷

As a result, the policy of a truly equal distribution is frequently sacrificed in favor of a more general incentive to maximize the value of the estate. Chapter 7 trustees have no duty to pursue preference actions to the overall detriment of the bankruptcy estate. It would be a truly harsh, vindictive, and inefficient law that would put the strict equality of creditors ahead of estate maximization, and one unlikely to retain many supporters. In other words, few would suggest, to use a famous analogy, that Solomon's proposal to split a newborn baby in half in order to satisfy the legally equal claims of two would-be mothers would have been a superior result to preserving the baby's life (thereby maximizing its value) and giving the child to one of the two women, even though doing so would necessitate unequal treatment.¹⁸⁸

However, it does not necessarily follow that in all scenarios the policy interest in equal distribution must fall victim to the interest in maximizing the estate. To the extent that the costs of recovering preferences are minimized, most preference proceedings both establish equality among creditors and increase the amount available for general distribution, at the expense of preferred creditors. As costs to the estate are reduced, an increasing number of preference actions satisfy both policy goals.

B. *THE POLICY OF EQUAL DISTRIBUTION IN CHAPTER 11*

The procedures and policy of bankruptcy reorganization are much less concerned with equal distribution. In theory, successful debtor reorganization in chapter 11 should have the effect of maximizing creditor repayment while simultaneously preserving the value of the debtor's business as a going concern,¹⁸⁹ thereby protecting individuals who would otherwise

Paints, Inc., 11 B.R. 930, 937 (Bankr. E.D.N.Y. 1981); Brendan Gage, *Is There a Statutory Basis For Selling Avoidance Actions?*, 22 NORTON J. BANKR. L. & PRAC. 3 art. 1 (May 2013).

186. Pursuant to 11 U.S.C. § 547(f), the debtor is presumed to have been insolvent on and during the 90 days prior to bankruptcy. However, no such presumption arises for transfers to or for the benefit of an insider in the year before the filing, requiring a higher showing of proof by the trustee. For an argument that the requirement of insolvency should be removed for insider cases, see Ponoroff, *supra* note 8, at 1508-14.

187. See Tom Connolly, Speaker at the Rocky Mountain Bankruptcy Conference, ABI Concurrent Session Giant Slalom: Hitting the Gates in Carrying Out the Duties of a Trustee or Examiner; Remedies for Creditors When the Gates Are Missed (Jan. 23, 2014) (noting that credit card companies and banks are more likely to repay preferences, whereas an individual's elderly mother makes a less desirable preference target).

188. See 1 *Kings* 3:16-28.

189. This assumes, of course, that the ultimate goal of a chapter 11 filing is reorganization; "Reorganization" is the title of chapter 11, accordingly, this seems at the outside to be a safe

bear the brunt of the business failure: employees, residents of plant towns, and other community members affected by a business closure.¹⁹⁰ Reorganization is accordingly permitted, with some limitations, even when some creditors of the bankruptcy estate might prefer liquidation proceedings as a faster, less risky, or more efficient method of ensuring at least partial repayment.¹⁹¹ Most of the discussion regarding the purpose of business reorganization tends to question the extent to which bankruptcy law should account for the interests of non-creditors who would also be affected by the debtor's failure, and permit reorganization even over the objections of creditors.¹⁹²

Lost in this discussion is the policy of equal distribution among creditors. The overarching purpose of bankruptcy reorganization is to resuscitate potentially profitable companies—ensuring that one creditor is paid no more than another is a secondary goal at best. In chapter 11, the DIP retains greater flexibility when it comes to creditor repayment than the pro rata scheme required for bankruptcy liquidation. The DIP may propose a repayment plan that gives some creditors a greater proportionate payout than others, limited only by the admonition that the plan does not “discriminate unfairly,”¹⁹³ and the baseline that no creditor receive less than it would have under a chapter 7 liquidation.¹⁹⁴ It can accomplish this by placing creditors in classes,¹⁹⁵ and

assumption. However, it is well documented that chapter 11 may also be used as a method of liquidation, and data suggests that it is increasingly so used. See discussion *infra* Part III.C.

190. See Butler & Gilpatric, *supra* note 24, at 284; Jonathan C. Lipson, *The Shadow Bankruptcy System*, 89 B.U.L. REV. 1609, 1613-14 (2009); Warren, *supra* note 25, at 787-88. In practice, of course, this may not be possible. Even in the best of situations, businesses may fail for reasons associated with economic fluctuations, natural disasters, or other events difficult to predict in advance. Debtors in a chapter 11 case are in far from the best of situations, frequently undercapitalized and overleveraged, with a history of failure and creditors who may be even less cooperative than under normal circumstances. Filing for bankruptcy can also impose additional costs on a struggling debtor that can exacerbate these problems. See SOL STEIN, A FEAST FOR LAWYERS 11-14 (1989); Edith H. Jones, *Chapter 11: A Death Penalty for Debtor and Creditor Interests*, 77 CORNELL L. REV. 1088, 1091 (1992).

191. This may be particularly true for secured creditors, who might expect full repayment upon liquidation, with reorganization providing no additional benefit. See WARREN ET AL., *supra* note 24, at 430.

192. See *supra* notes 24-25 and accompanying text.

193. See 11 U.S.C. § 1129(b)(1) (2012); see also discussion *supra* note 191 and *infra* note 195 regarding cramdown.

194. See 11 U.S.C. § 1129(a)(7). This provision is commonly known as the “Best Interests Test.” See TABB, *supra* note 23, at 103.

195. See 11 U.S.C. § 1122(a) (providing that claims may only be classified together if they are substantially similar to each other, but failing to state that similar claims must be classified together). There are some judicially created constraints on classification as reflected in case law. See Phoenix Mut. Life Ins. Co. v. Greystone III Joint Venture (*In re Greystone III Joint Venture*), 995 F.2d 1274, 1279 (5th Cir. 1991) (identifying as “the one clear rule that emerges from otherwise muddled caselaw” that “thou shalt not classify similar claims differently in order to gerrymander an affirmative vote on a reorganization plan”); Teamsters Nat’l Freight Indus. Negotiating Comm. v. U.S. Truck Co. (*In re U.S. Truck Co.*), 800 F.2d 581, 586 (6th Cir. 1986)

then providing each class with its own schedule for repayment.¹⁹⁶ In a chapter 11 plan, individual creditors may also receive additional benefits if they agree to provide financing to the debtor post-petition.¹⁹⁷ Further, some creditors may demand, and be given, better treatment to the extent that their votes, for reasons of size or particular classification, are necessary for confirmation of the chapter 11 plan. Because of this latitude, it is possible for a particular creditor or group to receive preferential treatment in chapter 11 compared with other creditors who are similarly situated, but strategically less important to the debtor on a forward-looking basis.

The true exceptions to preference liability reflect this permissive attitude regarding unequal treatment of creditors. Transfers that provide a benefit to the estate in the days leading up to bankruptcy are not avoided, because the law is more concerned with ensuring the debtor's continuing survival than policing the absolute equality of creditor payout. Accordingly, similarly situated creditors do not necessarily receive an equal distribution of the estate as a consequence of preference policy, even though this is the stated rationale for permitting the avoidance of preferential transfers in the first place.¹⁹⁸ The discretion afforded to a chapter 11 DIP also reflects this ordering of priorities. A DIP may elect not to pursue certain avoidable preferences even in the absence of an applicable exception. Although there is some oversight of a DIP's decision in this matter,¹⁹⁹ preferences can be permitted to stand,

("We agree . . . that there must be some limit on a debtor's power to classify creditors in such a manner. The potential for abuse would be significant otherwise."); *see also* King F. Tower, "Cramdown" Confirmation of Single-Asset Debtor Reorganization Plans Through Separate Classification of the Deficiency Claim—How In *Re U.S. Truck Co. Was Run Off the Road*, 36 WM. & MARY L. REV. 1169, 1170 (1995) ("Depending upon which court hears the case, such separate classification amounts to either an improper manipulation of the Code's voting process or a legitimate use of the Code's unambiguous provisions on reorganization.").

196. *See* 11 U.S.C. § 1123(a)(4) (providing that all claims within a given class receive the same treatment).

197. *See id.* § 364(c); *In re* Hubbard Power & Light, 202 B.R. 680, 685 (Bankr. E.D.N.Y. 1996) (approving priming lien to post-petition financier).

198. *See supra* notes 6–8 and accompanying text.

199. As in chapter 7, there are some restrictions on a DIP's decision whether or not to pursue a preference action. *See supra* Part II. As an initial matter, any decision regarding a possible preferential transfer would probably need to be included in the debtor's disclosure statement and/or plan, which would be distributed to the court, the UST, and all creditors. *See* 11 U.S.C. §§ 1123, 1125(a); *Harstad v. First Am. Bank*, 39 F.3d 898, 903 (8th Cir. 1994) ("Creditors have the right to know of any potential causes of action that might enlarge the estate—and that could be used to increase payment to the creditors."). The UST has the opportunity to be heard on the adequacy of a disclosure statement, and the statement must be approved by the court prior to the submission of any plan to creditors or the solicitation of votes for a plan. 11 U.S.C. §§ 1125(b), (d). In addition, a majority of courts have ruled that a creditor derivative action may be available if the DIP declines to pursue a meritorious action. *See* Official Comm. of Unsecured Creditors of Cybergene Corp. *ex rel.* Cybergene Corp. *v.* Chinery, 330 F.3d 548, 568–69 (3d Cir. 2003) (permitting a creditors' committee derivative standing to pursue an action to avoid a fraudulent transfer when the DIP refused, thereby violating its fiduciary duty to maximize the estate); *Canadian Pac. Forest Prods. Ltd. v. J.D. Irving, Ltd.*, (*In re* Gibson Grp., Inc.), 66 F.3d 1436, 1438–39 (6th Cir. 1995) (permitting a

particularly if the DIP can establish a convincing case that the cooperation of the defendant creditor is necessary for the successful implementation of a plan of reorganization.²⁰⁰

In chapter 11, the policy of equal distribution will consistently take second priority on the theory that permitting the business to continue as a going concern will maximize the overall distribution for creditors and the welfare of others associated with the business. Although manifestly unfair inequities are prohibited, a strict policy of equal distribution has no place in the more flexible standards accorded to reorganizing businesses.

C. REORGANIZATION AS LIQUIDATION IN CHAPTER 11

Unfortunately for the ease of dividing policy along the lines of liquidation and reorganization, there is a well-documented and growing trend of companies using chapter 11 to accomplish what is in essence liquidation.²⁰¹ This may be accomplished through filing a chapter 11 plan that anticipates the sale of the company, or, with growing frequency, the sale of assets, subject to court approval, even before a plan is filed.²⁰² Although many of these sales are conducted to preserve the going concern value of the business—a core justification for any plan of reorganization—a sale may also be conducted in chapter 11 in the same form it would have taken in a chapter 7, with assets auctioned off piecemeal.²⁰³

creditor to initiate an avoidance action instead of the DIP if the creditor has alleged a colorable claim, made an unanswered demand on the DIP to pursue the claim, and the DIP's refusal is unjustified in light of statutory obligations and fiduciary duties). *But see* Haller, *supra* note 65, at 397–405 (arguing that permitting such derivative actions is contrary to the plain meaning of the Code). Finally, creditors who are unhappy with a debtor's decision not to avoid a preferential transfer may express their displeasure by voting against the debtor's plan, preventing its implementation, or at least forcing the debtor to comply with the "cramdown" provisions of the Bankruptcy Code. *See generally* 11 U.S.C. § 1129(b); TABB, *supra* note 23, at 1150–53.

200. *See* Benjamin R. Norris, *Bankruptcy Preference Actions*, 121 BANKING L.J. 483, 512–13 (2004) (suggesting that DIPs may be willing to compromise on preference claims when hoping to maintain a relationship with the targeted creditor).

201. *See* Chad P. Pugatch et al., *The Lost Art of Chapter 11 Reorganization*, 19 U. FLA. J.L. & PUB. POL'Y 39, 62–63 (2008); Elizabeth Warren & Jay L. Westbrook, *Remembering Chapter 7*, AM. BANKR. INST. J., May 2004, at 22; *see also In re All Am. of Ashburn, Inc.*, 40 B.R. 104, 108 (Bankr. N.D. Ga. 1984) (denying creditors' motion to convert case to chapter 7 on the grounds that permitting liquidation under chapter 11 "would be more time and cost efficient" than going forward in chapter 7); *Field Hearing at Austin Friday, November 22*, ABI COMM'N TO STUDY THE REFORM OF CHAPTER 11 (noting that a survey conducted among Texas practitioners in chapter 11 found that chapter 11 is different than 10 years ago by virtue of the increased use of 11 U.S.C. § 363 sales or liquidation).

202. *See* 11 U.S.C. § 363(b) (stating that after notice and a hearing, the trustee may sell property of the estate outside of the ordinary course of business); Jacob A. Kling, *Rethinking 363 Sales*, 17 STAN. J.L. BUS. & FIN. 258, 262 (2012). *See generally* Elizabeth B. Rose, Comment, *Chocolate, Flowers, and § 363(b): The Opportunity for Sweetheart Deals Without Chapter 11 Protections*, 23 EMORY BANKR. DEV. J. 249 (2006).

203. *See* Pugatch et al., *supra* note 201, at 61–64 (discussing the use of a "liquidating trust" in chapter 11).

Justification for permitting such “chapter 11 liquidations” is found most frequently in the efficiency of using preexisting management to liquidate rather than bringing in and paying a trustee to accomplish the same task. Arguably, the DIP is able to obtain a better price for estate assets, both by virtue of its connections in the relevant field and its superior ability to operate the business until the most beneficial deal can be reached.²⁰⁴ The wisdom of permitting such a sale in chapter 11 has been vigorously debated however,²⁰⁵ and such practices raise legitimate questions regarding the role of chapter 7 in business bankruptcy, and by extension, the role of the policies and values that inform a chapter 7 distribution.

Although these broader questions are outside the scope of this Article, the ability of businesses to liquidate in chapter 11 through a piecemeal sale of assets (rather than sale as a going concern) must inform the ultimate recommendation for dealing with preference actions. If chapter 11 is used as a liquidating chapter rather than an opportunity to preserve a debtor’s going concern value, then policy considerations associated with a chapter 7 liquidation should predominate, and the availability of preference actions adjusted accordingly.²⁰⁶ This may undermine the effort to cleanly distinguish between liquidation and reorganization cases.

Recognizing this conflict, for ease of explanation this Article will continue to refer to the policy considerations tied up in chapter 11 and chapter 7 as if chapter 11 operated exclusively to preserve going concern value, rather than debtor control. Presumably, any measures taken to adopt the proposal advocated below would need to account for chapter 11 “liquidations,” perhaps by requiring conversion to chapter 7 once preservation of the business as a going concern is no longer at issue, permitting a chapter 11 trustee or DIP to pursue preference actions once a liquidating plan is confirmed, or a similar approach.

III. PART THREE: PROPOSALS FOR RECONCILIATION

Despite its apparent importance in the legislative history,²⁰⁷ it is evident that, depending on the particular chapter, policymakers are less concerned with ensuring that all creditors receive an equal portion of the debtor’s estate than they are with maximizing the overall amount distributed to creditors, or the benefit to other parties interested in the debtor’s survival. Similarly, creditors seem more preoccupied with the costs of defending against preference actions than the moral victory in seeing a fellow creditor subject

204. See Robert P. Simons, *Liquidating Assets Through a Chapter 11 Sale and Plan of Liquidation Rather Than a Chapter 7 Liquidation*, in CHAPTER 7 COMMERCIAL BANKRUPTCY STRATEGIES, available at 2013 WL 936230 at *3, *8; Warren & Westbrook, *supra* note 201, at 22.

205. See Warren & Westbrook, *supra* note 201, at 22.

206. Otherwise, this proposal runs the risk of making chapter 11 a safe haven for creditors who would otherwise be subject to a preference action.

207. See Countryman, *supra* note 36, at 748.

to the exact same pro rata distribution.²⁰⁸ Recognizing this, the question becomes how to shape preference law in such a way that it responds to these concerns without sacrificing more of its underlying justification—equal distribution—than is necessary to meet conflicting policy goals. The solution is to adapt preference law by chapter, maintaining principles of equal distribution when reasonable and abandoning them when not.²⁰⁹

A. PREFERENCES BY CHAPTER

The relative unimportance of equal distribution in chapter 11 suggests that maintaining preference actions in the reorganization context is a misguided effort. The incongruity between the overarching motivations for reorganization and preference policy creates a tension that cannot be resolved, and is only exacerbated, by establishing multiple, broadly defined exceptions. Instead, many of the concerns associated with preference law that are relevant in a reorganization context, like egregious overreaching or fraud, can be managed by other provisions of the Bankruptcy Code. More general preference liability, embodying a strict policy of equal distribution, should be reserved for cases of liquidation, where the pro rata distribution is more important. In these cases, the costs of preference actions should be minimized by eliminating true exceptions, particularly those intended to promote the debtor's ongoing business. Continuing to avoid preferences in the liquidation context will provide appropriate deterrence to creditors who might otherwise "race to the courthouse," even in situations where the debtor opts for reorganization over liquidation.

1. Chapter 11

Chapter 11 places reduced emphasis on equality of distribution among creditors. Accordingly, a strict policy of equal distribution in reorganization cases is misplaced. The availability of preference actions serves only to discourage interactions with the debtor in the period leading up to bankruptcy, for fear that creditors who engage in business with the debtor may subsequently be subject to an avoidance action.²¹⁰ The exceptions are intended to displace that fear, but are inadequate because of the costs associated with defending a preference action and the uncertainty about the scope of the exceptions themselves.²¹¹ Given the lack of priority placed on absolute equality, even among similarly situated debtors, preference law is both unnecessary and unwelcome in the reorganization context.

208. See Comments of Kathy Tomlin, *supra* note 16.

209. This proposal may be informed by the reality that chapter 11 can and has been used to accomplish a liquidation, rather than a reorganization. See discussion *supra* Part III.C.

210. See *supra* Part III.B.

211. See *supra* notes 16–19 and accompanying text.

This is not to say that there is no value in ensuring parity among similarly situated creditors in a chapter 11 case, or that the creditors themselves might not view this as a priority. To the contrary, there is a lingering concern for equality among equals in chapter 11. This is represented by both the requirements that all members of a class receive equal treatment in a reorganization plan and the existence of judicial scrutiny regarding classification. Further, creditors as a group may well object to the debtor's preferential treatment of particular creditors, and chapter 11 permits creditors to exercise their objections by raising them before the court²¹² or voting against the proposed plan.²¹³ Even more importantly, most concerns associated with the extreme or "idiosyncratic"²¹⁴ transfers that would be undisputed targets of preference law can be addressed by alternative Bankruptcy Code provisions. For example, transfers made with an intent to "hinder, delay, or defraud" creditors are already subject to avoidance outside of preference law pursuant to restrictions on fraudulent transfers.²¹⁵ In addition, a trustee's strong-arm powers,²¹⁶ which permit the trustee to avoid transfers that would be avoidable under applicable state law, could be used to target transfers to insiders at a time that the insider had reasonable cause to believe that the debtor was insolvent.²¹⁷ Further, in cases where unfair transfers could only be addressed by preference law, it could be exercised by converting the case to chapter 7, as discussed below.²¹⁸ In this way, lingering concerns regarding equal distribution in chapter 11 could be satisfied without using preference law.

2. Chapter 7

Freed from the concerns associated with preserving the debtor as a going concern, preference law can return to its purpose of equal distribution in the liquidation context. In chapter 7, the primary policy concern is maximizing the estate for distribution to creditors, with the requirement that that distribution will be equal as to similarly situated creditors.²¹⁹ A chapter 7 liquidation requires that all existing, non-exempt assets be sold or otherwise disposed of, with the proceeds going to creditors. For individuals, this

212. See 11 U.S.C. § 1103(c) (2012).

213. See *id.* § 1126(a); ELIZABETH WARREN & JAY LAWRENCE WESTBROOK, *THE LAW OF DEBTORS AND CREDITORS* 697 (3d ed. 1996) (stating that the power of creditors to reject a plan is the most important check on a debtor).

214. See *In re Tolona Pizza Prods. Corp.*, 3 F.3d 1029, 1033 (7th Cir. 1993).

215. See 11 U.S.C. § 548.

216. See *id.* § 544.

217. See UNIF. FRAUDULENT TRANSFERS ACT (UFTA) § 5(b) (1984). The UFTA has been adopted by the majority of states.

218. See 11 U.S.C. § 707(b).

219. See *id.* § 726(b) (providing for payments to be "made pro rata among claims" in each particular class or grouping).

implicates the principle of a “fresh start”: all post-petition assets are the debtor’s, but all non-exempt pre-petition assets go to the estate.²²⁰ For corporate entities, chapter 7 is a place to expire; businesses are given no “fresh start,” but instead divided among creditors until nothing remains.²²¹ Accordingly, chapter 7 is not at all concerned with encouraging ongoing business relations with the debtor, and any past efforts to save the debtor from liquidation must be deemed ineffective, or at the least, inadequate. Instead, the concern that all creditors be treated fairly—meaning subject to equal terms of distribution—is predominant.

Chapter 7 is also concerned with maximizing the proceeds from disposition of estate assets and minimizing the costs associated with recovery of those proceeds. Accordingly, the best policy in chapter 7 would enable trustees to recover preferential transfers as swiftly and cheaply as possible.

This could be accomplished on multiple fronts. First, limiting or removing the existence of “true” exceptions would expand the number of transfers subject to avoidance and reduce the cost and time necessary to recover them. In addition, the presumption of insolvency could be expanded past the 90-day period to include a more substantial period of time, thereby reducing the trustee’s burden to show insolvency in proceedings to recover transfers from insiders.²²² Finally, the law could provide stronger incentives for the swift return of preferences by establishing a set rate of interest accrual on an unrecovered preference, for which the transferee would be liable unless the preference were returned within a reasonable period of time.²²³

Although these amendments are unlikely to eliminate the costs of pursuing preference actions entirely, they would significantly streamline the process. Creditors might still resist an action to avoid transfers by arguing that they do not fit the definition of preferences. However, resolution of these defenses is likely to take less time, and substantially fewer estate resources, than determination of the current exceptions. Absent such exceptions, in most situations a defendant creditor would have great difficulty in presenting a defense that could proceed past summary judgment. For example, creditors have historically struggled to present sufficient evidence to overcome the statutory presumption of insolvency.²²⁴

Preference liability in the liquidation context will reinforce the policy of deterring creditors’ “race to the courthouse,” even where the debtor will ultimately file for chapter 11 and general preference liability will not come into play. This is because creditors cannot always predict what chapter a

220. See *id.* § 541.

221. See *id.* § 522(b) (extending exemptions to individual, not corporate, debtors).

222. See Ponoroff, *supra* note 8, at 1512.

223. Recovery of interest is already available upon a showing of good cause in some courts. See *Kelley v. Chevy Chase Bank (In re Smith)*, 236 B.R. 91, 109–04 (Bankr. M.D. Ga. 1999).

224. See *Sanyo Elec., Inc. v. Taxel (In re World Fin. Servs. Ctr., Inc.)*, 78 B.R. 239, 241 (B.A.P. 9th Cir. 1987), *aff’d*, 860 F.2d 1090 (9th Cir. 1988).

debtor may file in, and a debtor may convert a case from one chapter to another.²²⁵ Unfortunately, the converse of this observation is that the purported benefit of preference exceptions, to encourage creditor relations despite a debtor's financial struggles,²²⁶ may also be undermined in the chapter 11 context due to this uncertainty. Presumably, if a case converted from chapter 11 to chapter 7, transfers that previously were safe from preference avoidance actions could then be subject to them.²²⁷

In analyzing the scope of this problem, the possible impact of preference law on creditor behavior²²⁸ and the extent of preference liability as a disincentive to ongoing business relationships should not be overstated. Even under a strict liability model, simultaneous exchanges would continue to be protected,²²⁹ permitting creditors to continue doing business with the debtor on those terms.²³⁰ Further, creditors may have independent incentives to continue doing business with a debtor even in the days leading up to bankruptcy—like preserving a supply relationship, or retaining a customer.

It is possible that introducing strict preference liability in chapter 7 will, due to reluctance to extend credit to floundering debtors, encourage a marginally higher number of bankruptcies. It is difficult to predict the number of businesses that would be affected or the net loss incurred (i.e., whether a bankruptcy caused by a tighter credit market will represent an overall loss in value to society, and what the amount of that loss will be). Due to this uncertainty, it is also difficult to say if those costs would be offset by the savings accruing from the reduced costs associated with pursuing and recovering a preference.

However, businesses faced with such a credit dry-up will likely file under chapter 11 rather than chapter 7, if for no other reason than an initial filing under chapter 7 is an admission of defeat, wherein the debtor relinquishes control of the business and resigns itself to liquidation.²³¹ Recognizing that most businesses who can file under chapter 11 will do so may also ameliorate

225. See 11 U.S.C. § 707(b).

226. See Afilalo, *supra* note 26, at 635; Broome, *supra* note 3, at 85; Palazzolo, *supra* note 30, at 881.

227. See 11 U.S.C. § 546(a) (setting the statute of limitations for avoiding powers at the later of two years after filing or one year after the appointment of a trustee). With a division in preference law between chapter 7 and chapter 11, § 546 would likely need to be amended to clarify that the statute of limitations would expire one year after the appointment of a trustee in chapter 7, in the case of conversion from 11 to 7.

228. See *supra* text accompanying notes 58–60.

229. See Tabb, *supra* note 26, at 1024 (noting that “if the debtor truly is in difficult straits, a careful creditor will insist on C.O.D. transactions no matter what the preference law says”).

230. See *supra* text accompanying notes 74–81 (discussing the substantiality of the contemporaneous narrowing exception).

231. See WARREN & WESTBROOK, *supra* note 213, at 388–89 (“[T]he business debtor almost never wants to liquidate because, unlike the individual debtor, there is no advantage for the company in liquidation. . . . Liquidation is, as the term suggests, death.”).

creditor anxiety about transfers with a struggling debtor. If the debtor will survive outside of bankruptcy or through chapter 11, then there is no risk to receiving payment from the debtor. If the debtor will fail and subsequently seek liquidation in bankruptcy, then the creditor must expect pro rata treatment based on strict equal distribution principles.²³² Under this analysis, a creditor will only refuse to do business with a debtor it believes is likely to ultimately fail and file for liquidation when the benefits of continuing to do business with the debtor will not outweigh the anticipated loss the creditor will experience as a consequence of the bankruptcy. But in such a scenario, this may be the preferable outcome, or at least what is to be expected in a normal free market. Accordingly, the potential for such an outcome does not overcome the benefits of a more streamlined system of preference liability.

CONCLUSION

Preference law has become unpopular, at least among creditors,²³³ in large part because it is costly and difficult to predict. In addition, preference policy has lost its theoretical cogency through efforts to reconcile equal distribution with a system that does not prioritize strict equality over other values. The many exceptions to preference liability undercut the principle purpose behind its imposition—to ensure that all similarly situated creditors receive an equal proportion of the debtor's assets. These exceptions also impose costs on the trustee and the transferee, decreasing the likelihood that their recovery will represent an overall benefit to the bankruptcy estate.

The solution to these problems is not to further amend or expand exceptions, but to do away with general preference liability when a strict policy of equal distribution is not a priority, and more firmly establish preference liability when it is. Accordingly, the Bankruptcy Code should be amended to disregard the current section on preferences in a case of bankruptcy reorganization. In addition, the Bankruptcy Code should remove the true exceptions to preference liability in the context of bankruptcy liquidation, thereby promoting a strict equality of distribution, regardless of the creditor's intent or motivation, and maximizing the estate by reducing the costs of preference actions. These actions may not make preferences popular, but they will reduce the inconsistencies and costs surrounding preference law.

232. This assumes restrictions on the availability of chapter 11 liquidations, as discussed *supra* text accompanying notes 201–06.

233. As others have noted, and as this author has personally experienced, preference law remains an engaging and interesting topic for classroom discussion. See Morris, *supra* note 1, at 737.