View metadata, citation and similar papers at core.ac.uk

brought to you by CORE

provided by University of Oklahoma College of Law

Oklahoma Law Review

Volume 71 | Number 4

2019

Relational Preferences in Chapter 11 Proceedings

Brook E. Gotberg

Follow this and additional works at: https://digitalcommons.law.ou.edu/olr

Part of the Bankruptcy Law Commons

Recommended Citation

Brook E. Gotberg, *Relational Preferences in Chapter 11 Proceedings*, 71 OKLA. L. REV. 1013 (2019), https://digitalcommons.law.ou.edu/olr/vol71/iss4/3

This Article is brought to you for free and open access by University of Oklahoma College of Law Digital Commons. It has been accepted for inclusion in Oklahoma Law Review by an authorized editor of University of Oklahoma College of Law Digital Commons. For more information, please contact darinfox@ou.edu.

RELATIONAL PREFERENCES IN CHAPTER 11 PROCEEDINGS

BROOK E. GOTBERG*

It is no secret that creditors hate so-called "preference" actions, which permit a debtor to recover payments made to creditors on the eve of bankruptcy for the benefit of the estate. Nominally, preference actions are intended to equalize the extent to which each unsecured creditor must bear the loss of a bankruptcy discharge, or to discourage creditors from rushing to collect from the debtor in such a way that will push an insolvent debtor into bankruptcy. But empirical evidence strongly suggests that, at least in chapter 11 reorganization proceedings, preference actions do not fulfill either of these stated goals. Interviews with debtors, trade creditors, and attorneys involved in small- and medium-sized chapter 11 bankruptcy cases establish both that creditors are not deterred from collecting by preference actions, and that preference actions are not applied equally in a system where debtors are able to choose which preferential transfers to avoid and how much to accept in settlement of preference actions. Instead, these interviews suggest an alternative justification for preference law in chapter 11, one more consistent with promoting a debtor's ability to exercise strategic leverage over its creditors in an effort to reorganize. In this way, the law of preference avoidance is actually one of preference perpetuation, and is exercised with an eye towards preserving valuable relationships within bankruptcy proceedings.

Introduction

In most bankruptcy proceedings, creditors correctly anticipate that the debtor will prove unable to repay all its debts in full, requiring unsecured creditors to write off most, if not all, of what they are owed. In common

* Associate Professor of Law, University of Missouri School of Law. My sincere thanks to those debtors, creditors, and attorneys who entertained my intrusive and occasionally naïve questions regarding their experience in bankruptcy proceedings as part of my research study on the effects of chapter 11 on business relationships between debtors and trade creditors, and to my faithful research assistants, Rebekah Keller ('17), Raymond Lee ('19) and Vikkie Southworth ('19), for their tireless efforts searching court records and transcribing interviews. Special thanks also to attendees of the 2018 ABI Young Bankruptcy Scholars Workshop and the Chicagoland Junior Scholars Works in Progress Conference, and to the faculties of the University of Iowa College of Law, J. Reuben Clark Law School and Washburn University School of Law, especially Pat Bauer, Paul Stancil, and Andrea Boyack, for their thoughtful comments. Any errors are my own.

Published by University of Oklahoma College of Law Digital Commons, 2019

parlance, bankruptcy is synonymous with nonpayment of debt, and unsecured creditors are usually the last to be paid pursuant to existing schemes of priority.[1] Accordingly, the loss comes as no surprise. However, creditors are frequently surprised to learn that in chapter 11 bankruptcy proceedings the debtor can demand the return of payments it has made to creditors in the ninety days prior to bankruptcy; these payments are generally referred to as "preferential transfers," and the debtor can recover the "preference" from the creditor.[2]

Section 547 of the Bankruptcy Code defines a preferential transfer as one made to or on behalf of a creditor for a pre-existing debt in the ninety days before the bankruptcy filing,[3] so long as the transfer afforded the creditor more than it would have received under a chapter 7 distribution.[4] When a creditor receives notice of a preference action, it must return the amount it received during the preference period or present a defense establishing that the transfer falls within one of the exceptions delineated in the statute.[5] If the creditor fails to present a defense, any claims it may have against the debtor's estate will be disallowed,[6] and a judgment may be entered against the creditor in the amount of the avoided preference.

While common, preference actions are not well understood among the creditor population, particularly those experiencing their first bankruptcy.[7]

---

1. *See, e.g.*, 11 U.S.C. § 722 (2018).

2. After being sued to return fees paid, one creditor reflected, "Well, I don't know what it's called . . . I certainly have no preference for it at all." *See* Telephone Interview with PC (Sept. 7, 2017). Each interview cited or referenced in this Article has been stripped of identifying information and is on file with the author. *See* discussion *infra* notes 107-215.

3. This ninety-day period is termed the "preference" period. 11 U.S.C. § 547.

4. *Id.* If the creditor is unsecured, and the bankruptcy payout in chapter 7 for unsecured creditors would be less than one hundred cents on the dollar, this requirement is always met. *See* Vern Countryman, *The Concept of a Voidable Preference in Bankruptcy*, 38 VAND. L. REV. 713, 736-37 (1985). Preference actions are also available under other sections of the Code, but the ramifications of preference in consumer bankruptcies or in liquidations are not discussed here.

5. *See* 11 U.S.C. §§ 547, 550. These exceptions include transfers that constitute substantially contemporaneous exchanges, payments in the ordinary course of business, the granting of a purchase money security interest, and transfers that are followed by the giving of new value to the debtor. *See* Brook E. Gotberg, *Conflicting Preferences in Business Bankruptcy: The Need for Different Rules in Different Chapters*, 100 IOWA L. REV. 51, 67-77 (2014).

6. *See* 11 U.S.C. § 502(d).

7. *See* 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

According to the legislative history, preference actions are permitted for two primary reasons: first, to promote equal distribution among creditors, and second, to discourage creditors from rushing to collect from an insolvent debtor, thereby pushing the debtor into bankruptcy.[8] Although both of these goals would nominally benefit unsecured creditors by helping to avoid unnecessary bankruptcies and by ensuring equal treatment among creditors within bankruptcy, preference actions remain a source of considerable vitriol among the creditor community.[9] Certainly, much of this distaste can be explained by the psychological concept of loss aversion.[10] However, an informed understanding of how preference actions are used in practice

---

payment that was lawful at the time but has become actionable upon the filing of bankruptcy."); *see infra* note 188 and accompanying text.

8. *See* H. REP. NO. 95-595, at 177-78 (1977) ("The purpose of the preference section is two-fold. First, by permitting the trustee to avoid prebankruptcy transfers that occur within a short period before bankruptcy, creditors are discouraged from racing to the courthouse to dismember the debtor during his slide into bankruptcy. . . . Second, and more important, the preference provisions facilitate the prime bankruptcy policy of equality of distribution among creditors of the debtor."); S. REP. NO. 95-989, at 98 (1978), *as reprinted in* 1978 U.S.C.C.A.N. 5787, 5874 (noting the general policy of preference law is deterring "unusual action" by the debtor or creditors); *see also* REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, H.R. DOC. NO. 93-137, pt. 1, at 202 (1973) [hereinafter COMMISSION REPORT ON BANKRUPTCY LAWS] (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."); Lawrence Ponoroff, *Evil Intentions and an Irresolute Endorsement for Scientific Rationalism: Bankruptcy Preferences One More Time*, 1993 WIS. L. REV. 1439, 1447, 1479; Robert Weisberg, *Commercial Morality, the Merchant Character, and the History of the Voidable Preference*, 39 STAN. L. REV. 3, 3 (1986); Richard B. Levin, *An Introduction to the Trustee's Avoiding Powers*, 53 AM. BANKR. L.J. 173, 184 (1979).

9. *See* Charles J. Tabb, *The Brave New World of Bankruptcy Preferences*, 13 AM. BANKR. INST. L. REV. 425, 439 (2005) ("[U]nless one's ox got gored more than average, economic rationality might argue for accepting a pro-trustee venue system. That economic argument, though, is utterly unpersuasive to trade creditors—a truth to which I personally can attest as Reporter for the ABI Preference Study, where I tried in vain to make that argument to the trade creditor representatives."); David Lander, *A Snapshot of Recent Avoidance Cases*, NORTON BANKR. L. ADVISER, Feb. 2004, 2004 NO. 2 NRTN-BLA 2 (Westlaw) (suggesting that defendants in preference actions are often dubious that the net total of preference recoveries significantly increases distribution to unsecured creditors).

10. Loosely defined, loss aversion refers to the phenomenon that the pain of loss is felt more keenly than the benefit of gain. *See* Sabrina M. Tom, Craig R. Fox, Christopher Trepel & Russell A Poldrack, *The Neural Basis of Loss Aversion in Decision-Making Under Risk*, SCIENCE, Jan. 2007, at 515, 515.

Published by University of Oklahoma College of Law Digital Commons, 2019

demonstrates that the distaste may also be justified by the simple fact that preferences are unequally enforced in chapter 11.

Chapter 11 reorganization is complex, unlike the relatively straightforward liquidation proceedings available in chapter 7. Consequently, there is more room for unequal treatment among creditors. Under chapter 7, the pro rata distribution of assets among similarly situated creditors[11] is overseen by an appointed trustee who has been vetted by the U.S. Trustee's Office for potential conflicts of interest.[12] In chapter 11 proceedings, the debtor, acting as a debtor-in-possession (DIP), proposes a plan to repay creditors.[13] This plan can and often does depart from the formulaic distribution set forth in chapter 7. The chapter 11 structure has been described as "a deal within a lawsuit":[14] the DIP must negotiate with creditors in order to obtain sufficient votes for a plan of reorganization that will also satisfy the court.[15] The creditors are undeniably invested in the debtor's survival, but their interests may also be fundamentally in conflict with those of the debtor and other effected parties. Litigation is expected and common,[16] reflecting both the creditors' interests in forcing the debtor to provide them more favorable payment terms and the debtor's interest in forcing creditors to be satisfied with less.

Beyond the need for creditor support for the plan, a DIP, unlike a chapter 7 trustee, will also be concerned with the ongoing viability of the company. Viability will be influenced by the willingness of trade partners to continue doing business with a debtor. When trade partners are owed money in the bankruptcy, they are referred to as trade creditors. Some trade creditors may prove essential to the debtor's ongoing viability, and will accordingly warrant different treatment than other, less essential creditors.

Consider the following generic example. Debtor Daniels runs a molded fiber company, which uses recycled paper pulp to manufacture packaging material. In order to run his day-to-day operations, he requires working capital, which is provided by his lender, Green Bank. Green Bank holds a security interest in Daniels' inventory and equipment. By virtue of its

---

11. *See* 11 U.S.C. § 726(b) (2018).

12. *See* 28 U.S.C. § 586(a)(1); 11 U.S.C. § 701; U.S. DEP'T OF JUSTICE, HANDBOOK FOR CHAPTER 7 TRUSTEES 2-7 (2012), https://www.justice.gov/ust/file/handbook_for_chapter_7_trustees.pdf/download.

13. 11 U.S.C. § 1121 (2018).

14. Credit to Judge Dennis Dow, Western District of Missouri.

15. *See* 11 U.S.C. § 1129.

16. For an explanation of contested matters in bankruptcy, see Paul P. Daley & George W. Shuster, Jr., *Bankruptcy Court Jurisdiction*, 3 DEPAUL BUS. & COM. L.J. 383, 409 (2005).

security interest, Green Bank is entitled either to payment in full or to possession of its collateral. This right is preserved in bankruptcy.[17] Accordingly, Daniels must pay Green Bank or be shut down. In addition, Daniels owes money to Owen's Ovens pursuant to a maintenance and parts agreement. Owen's Ovens is the only local company with the ability to maintain the ovens Daniels needs to manufacture his products. Daniels also owes money to Patty's Paper Pulp, which provides him with the raw materials he needs for his packaging material. However, unlike the oven maintenance, paper pulp is available from a variety of local vendors. In bankruptcy, Daniels will be most concerned about obtaining Green Bank's cooperation, but also highly aware of his need to mollify Owen's Ovens, even if doing so is at the expense of Patty's Paper Pulp, with whom he has a more expendable business relationship.

Consequently, Patty is likely to be treated differently in the bankruptcy than Owen, even though both are unsecured creditors, nominally subject to a pro rata distribution. Empirical evidence pulled from interviews with parties who have been involved in chapter 11 bankruptcy proceedings suggests that this unequal treatment extends to preference actions; the creditors who are sued for a preference by a DIP tend to be those who are less important to the debtor or less essential to the debtor's reorganization.[18] Conversely, a debtor generally avoids filing lawsuits against parties with whom it intends to preserve a long-term relationship.

Notions of equality simply do not come into play when a DIP is fighting for its survival. A DIP is not technically required to bring an available preference action, although the debtor's flexibility in this regard is highly debated.[19] The applicable language in § 547 indicates that the DIP "may" bring the preference action, signifying a permissive standard.[20] Some have

17. *See* 11 U.S.C. § 506(a). For a discussion regarding the extent of a secured creditor's rights in bankruptcy, see Melissa B. Jacoby & Edward J. Janger, *Tracing Equity: Realizing and Allocating Value in Chapter 11*, 96 TEX. L. REV. 673 (2018) (arguing for a distinction between claims to priority and claims to residual value); Christopher W. Frost, *Secured Credit and Effective Entity Priority*, 51 CONN. L. REV. (forthcoming 2019) (arguing that secured creditors can effectively establish priority over the entity).

18. *See* discussion *infra* notes 190-93.

19. *See* discussion *infra* notes 194-98.

20. The language of section 547 also applies to a chapter 7 trustee. However, unlike a DIP in chapter 11, a chapter 7 trustee is unlikely to refrain from pursuing a preference action unless doing so would be a losing strategy pursuant to a cost benefit analysis. Chapter 7 trustees are totally unconcerned with the preservation of ongoing business relationships in light of liquidation, and are compensated pursuant to the amount they bring into the estate. *See* 11 U.S.C. § 326; Telephone Interview with CA (May 25, 2017) ("Now, Chapter 7 is

Published by University of Oklahoma College of Law Digital Commons, 2019

argued that the DIP's fiduciary duty to the estate would require bringing any such existing claim, while others have argued that the language of the statute is deliberate, and the DIP can use its discretion in determining when a preference action would be detrimental to the chances of reorganization.[21]

The DIP's fiduciary duty to maximize the estate certainly suggests a duty to maximize preference recoveries pursuant to a cost-benefit analysis, although there is no clear direction on how costs and benefits should be measured.[22] Without the cooperation of certain preferred creditors, it is possible that the long-term health of the company will suffer and the repayment of creditors will be diminished, accordingly it may be better for the debtor to forgo recovery, or to offer a generous settlement agreement.[23] The debtor may also wish to settle rather than pursue a claim that appears more difficult, but not impossible, to prove. Indeed, settlement of preference claims is the rule, rather than the exception,[24] but there appears to be relatively little oversight of preference settlements. Settlement amounts are not typically reported in the case docket, and a DIP need not commit itself to

---

completely different because the trustees will just immediately do it. They'll do it for a $150 preference, they'll send the letter."); Telephone Interview with CA (May 30, 2017) ("I would say in my experience the trade creditors are being pursued by the Chapter 7 trustee, the liquidating trust trustee coming out of the bankruptcy so that there isn't an ongoing Chapter 11 debtor that needs the relationship . . . ."); Telephone Interview with DA (Sept. 8, 2017) ("When things meltdown, preferences are always on the table. . . .[in] a 7[] or a liquidating 11.").

21. *See* discussion *infra* notes 190-96. Requiring a DIP to bring a preference action any time it existed would result in a significantly different dynamic in chapter 11. Whether or not it would be advisable to do so in order to further the equality purposes of preferences is an intriguing issue not examined in this paper. I have elsewhere argued that, in chapter 7, preference liability should be automatic and absolute, without exceptions. Gotberg, *supra* note 5, at 90.

22. This fiduciary duty arises as a matter of law. *See In re* United Healthcare Sys., Inc., 200 F.3d 170, 177 n.9 (3d Cir. 1999) ("United Healthcare, as a debtor-in-possession, is a fiduciary for its estate and for its creditors."); *In re* J.T.R. Corp., 958 F.2d 602, 605 (4th Cir. 1992) ("The debtor-in-possession does not act in his own interests, but rather in the interests of the creditors."); Dunes Hotel Assocs. v. Hyatt Corp., 245 B.R. 492, 506 (D.S.C. 2000) ("A trustee or debtor-in-possession is a fiduciary that should act in the interests of the creditors, not in its own interests."); *In re* Brent Expls., Inc., 31 B.R. 745, 752 (Bankr. D. Colo. 1983) ("[A]t the filing of the bankruptcy petition the debtor becomes a new entity, the debtor-in-possession with its own rights and duties. . . . This second entity has a fiduciary duty to the estate.").

23. *See* Telephone Interview with CA (June 21, 2017) (noting the ability of a DIP to reach a favorable settlement with important creditors when forced to bring such an action under pressure from the court or other creditors).

24. *See* discussion infra notes 230-32.

https://digitalcommons.law.ou.edu/olr/vol71/iss4/3

pursue preference claims in the plan documents provided to creditors.[25] Following plan confirmation, a DIP is not required to bring available preference actions, which may be settled or even abandoned.[26] Accordingly, a broad reading of the "may" clause in § 547, combined with a great deal of flexibility in establishing settlement amounts, allows a DIP to favor some creditors over others using preference actions.

This Article makes the case that, by virtue of a debtor's flexibility to pursue actions against some creditors but not others, preference avoidance actions in chapter 11 have come to promote policy goals wholly divorced from those asserted by Congress in the legislative history. Preference law in chapter 11 should be understood as a strategic tool for chapter 11 debtors to wield in negotiations with creditors, and not as an effort to equalize repayment among creditors or to deter pre-bankruptcy collection efforts.[27] This theory is grounded primarily in data gathered from interviews with trade creditors, debtors, and bankruptcy attorneys involved in recently confirmed chapter 11 reorganizations. The principal benefit of personal interviews is that they can provide a clarity and richness to the discussion that is difficult to draw from other research devices, and they may reveal the motivations, intentions, or beliefs of the actors involved.[28] While findings from a limited set of interviews cannot support definitive statements regarding the world,[29]

---

25. *See* discussion *infra* note 195 and accompanying text.

26. *See* Telephone Interview with DA (Sept. 8, 2017) ("In a chapter 11, where the debtor proposes a plan and it gets confirmed and old management becomes new management and equity goes away, and unsecured creditors become equity, there really is no major push on preferences."); Telephone Interview with CA (June 21, 2017) ("[I]f you're a debtor and you have an ongoing business and you don't have the watchful eye of the creditor's committee or you're not constantly in front of the judge and you're kind of done with your case, your need at that point in time to file a preference action goes down precipitously."); Telephone Interview with DA (May 19, 2017) ("So, a lot of times, people wait until after the plan is confirmed and then sometimes they'll pursue those actions and sometimes not.").

27. *See* discussion *infra* note 208.

28. *See* Sergio Puig, *Does Bureaucratic Inertia Matter in Treaty Bargaining? Or, Toward a Greater Use of Qualitative Data in Empirical Legal Inquiries*, 12 SANTA CLARA J. INT'L L. 317, 320 (2013) ("Qualitative empirical research is as valuable as quantitative research, and provides possibilities for giving rich context to legal behavior."). Furthermore, the nature of preference settlements makes quantitative analysis inherently difficult. As most preference actions are settled prior to even a motion for summary judgment, the data on settlements and settlement negotiations is not easy to gather. *See* Telephone Interview with DA (Sept. 8, 2017) ("When it does come down and we have clients that do get sued for preference? They settle.").

29. *See* Ellie Fossey, Carol Harvey, Fiona McDermott & Larry Davidson, *Understanding and Evaluating Qualitative Research*, 36 AUSTL. & N. Z. J. PSYCHIATRY 717, 730 (2002);

Published by University of Oklahoma College of Law Digital Commons, 2019

these findings nevertheless provide valuable insight into how preferences function, and may point to further avenues of research.[30]

In a previous article, I reported that all creditors and attorneys interviewed in this study indicated that creditors would prefer to collect past due payments from the debtor when given the opportunity, and that attorneys would recommend doing so.[31] Although collection could provoke a preference action later on, interviewees noted that the expected result of preference claims was settlement with the debtor for substantially less than the preference amount.[32] This finding was consistent with broader theories on deterrence,[33] and demonstrated that preference law as written fails to discourage collection behavior because preference action "punishments" are both unlikely to be enforced and substantially less costly than the benefit of engaging in a collection action against the debtor.[34] In other words, all rational creditors would accept payments from the debtor in the ninety days before bankruptcy even if they knew that such a preference could be avoided in bankruptcy, and even if they suspected a bankruptcy filing was likely.

Here, I show that creditors in a long-term business relationship with a debtor may be willing to overlook a short-term financial loss associated with bankruptcy discharge in favor of preserving the long-term relationship; however, when a trade creditor is faced with the perception that the debtor deliberately "used" the creditor or abused the creditor's trust, creditors may instead choose to abandon the relationship.[35] Being sued for a preference is widely perceived as such an act of betrayal, and both debtors and their attorneys respond accordingly.[36] The evidence suggests that because preference litigation can severely undermine a trade creditor's willingness to continue a relationship with the debtor, preference litigation is limited to cases where the ongoing relationship is not a matter of concern.[37]

The result is that a DIP only brings preference actions against creditors that are *less* preferred. In this study, actions to avoid preferential transfers

Kelly J. Asmussen & John W. Creswell, *Campus Response to a Student Gunman*, J. HIGHER EDUC., Sept./Oct. 1995, at 575, 588.

30. *See* Fossey, *supra* note 30, at 730; THE SAGE HANDBOOK OF QUALITATIVE RESEARCH 8 (Norman K. Denzin & Yvonna S. Lincoln eds., 2011).

31. Brook E. Gotberg, *Optimal Deterrence and the Preference Gap*, 2018 BYU L. REV. 559, 611-12.

32. *Id.* at 588.

33. *Id.* at 565-72.

34. *Id.* at 621-22.

35. *See* discussion *infra* notes 133-52.

36. *See* discussion *infra* notes 169-78.

37. *See* discussion *infra* note 190.

were not intended to bring the targeted creditor back into parity with others. Instead, study participants reported using preference actions to encourage concessions from particular creditors,[38] to disallow the creditors' claims,[39] to exclude uncooperative creditors from voting on the plan of reorganization,[40] and to encourage the settlement or reduction of claims from these creditors.[41] Preference law was used as another method to extract concessions from creditors, especially those with whom the debtor did not seek an ongoing business relationship. These findings lead to the conclusion that preference law in chapter 11 requires a new theory of justification, one informed by relational concerns bound up in business dealings.

The Article proceeds as follows. Part One provides a brief explanation of the historical legislative rationale for preference actions in bankruptcy, academic criticism of these purported justifications, and an explanation of my prior work on the topic. Part Two introduces the sample group evaluated in this study—namely, trade creditors in small- and medium-sized chapter 11 bankruptcy reorganizations—and explains why they were particularly selected for evaluation. Part Three reports on study findings regarding how trade creditors viewed their business relationships with a debtor in cases of bankruptcy. Part Four discusses how preference actions impacted business relationships between trade creditors and debtors and explains how these results influenced decisions about when and where to bring preference actions. Part Five places these findings in the context of prior theoretical work regarding business relationships and suggests that preference actions may be better understood as a tool to manage business relationships in bankruptcy than as a method to ensure equality of distribution.

I. Preference Legislative History

Like much of modern American bankruptcy law, the idea of avoiding preferential transfers came from English laws on bankruptcy and insolvency, which were then adopted and incorporated into American jurisprudence. Historically, preference law closely resembled the law of fraudulent

---

38. *See* Telephone Interview with DA (July 17, 2017) ("Now, sometimes a debtor will use the threat of preference litigation to induce the creditor to do something.").

39. *See* Telephone Interview with CA (Aug. 8, 2017).

40. *See* Telephone Interview with DA (May 19, 2017) ("If they filed a proof of claim for ten million dollars but if you object and file a preference, then all of a sudden, it's not an allowed claim, they can't vote or receive anything unless they pay the preference back and it changes the negotiating posture with the creditor.").

41. *See* Telephone Interview with CA (May 18, 2017) ("And so, they filed this preference action just to put pressure on us to reduce our claim.").

Published by University of Oklahoma College of Law Digital Commons, 2019

conveyance.[42] It required a finding of intent as part of establishing liability—either the debtor's intent to favor one creditor over another[43] or the creditor's knowledge that such a transfer would be preferential.[44] 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, which indicated that the intent requirement was "the most troublesome feature" of current preference provisions, leading to much litigation, and that "intention should be irrelevant."[45]

Since the enactment of the Bankruptcy Code in 1978, preference law has moved away from analyzing the motivations of either the debtor or the creditor. Instead, it has purported to encourage equality among creditors by ensuring that a creditor that had the good fortune to be paid just before the bankruptcy filing is treated no differently than a creditor that was not paid in the days before bankruptcy.[46] Preference law as written is to be enforced regardless of the creditor's intention.[47] Instead, the legislative history

---

42. *See* Countryman, *supra* note 4, at 716-18; John C. McCoid, II, *Bankruptcy, Preferences, and Efficiency: An Expression of Doubt*, 67 VA. L. REV. 249, 250 (1981); Ponoroff, *supra* note 8, at 1448 n.21; Weisberg, *supra* note 8, at 4.

43. *See* Bankruptcy Act of 1841, ch. 9, § 2, 5 Stat. 440, 492 (repealed 1843) (declaring void and fraudulent all transfers of property made in contemplation of bankruptcy and for the purpose of giving a preference); Bankruptcy Act of 1867, ch. 176, § 35, 14 Stat. 517, 534 (repealed 1978) (declaring void and avoidable transfers made in contemplation of insolvency with a view to give a preference, and the existence of such transfers made outside the usual and ordinary course of business prima facie evidence of fraud).

44. *See* 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").

45. COMMISSION REPORT ON BANKRUPTCY LAWS, *supra* note 8, at 203-04 ("That [intent] requirement, more than any other, has rendered ineffective the preference section of the present Act.").

46. *See* Lissa Lamkin Broome, *Payments on Long-Term Debt as Voidable Preferences: The Impact of the 1984 Bankruptcy Amendments*, 1987 DUKE L.J. 78, 115 ("After Congress removed the 'reasonable cause to believe' requirement in 1978, the main goal of the preference provision was to preserve equality of distribution; the prevention of unusual pressure or action by the creditor became only an incidental objective."); Charles Jordan Tabb, *Rethinking Preferences*, 43 S.C. L. REV. 981, 990 (1992) (submitting that it should be irrelevant whether preferred creditors knowingly obtained payment from a debtor likely to seek bankruptcy relief or not).

47. *See Bankruptcy Act Revision: Hearings on H.R. 31 and H.R. 32 Before the Subcomm. on Civil and Constitutional Rights of the House Comm. on the Judiciary (pt. 2)*, 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

https://digitalcommons.law.ou.edu/olr/vol71/iss4/3

indicates that the underlying motivation is one of fairness;[48] because it is almost universally established that not all creditors will be paid in full, payment should at least be equal among creditors holding similar legal rights.[49] Although commentators disagree on the appropriate focus of preference law, they largely agree that the original motivation for establishing preference liability was to establish equality among creditors.[50]

In England, preference liability still hinges on a showing that the debtor intended to favor one creditor over another, and a creditor may defend against preference liability by demonstrating that payment was prompted by the creditor exercising real commercial influence over the debtor, such as by

---

one had knowledge and one did not of the insolvency of the debtor, that has really no relevancy to equality of treatment.").

48. *See* H.R. REP. NO. 95-595, at 340 (1977), *as 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."); H.R. REP. NO. 95-595 at 177-78, *reprinted in* 1978 U.S.C.C.A.N. at 6138 ("[T]he preference provisions facilitate the prime bankruptcy policy of equality of distribution among creditors of the debtor."); COMMISSION REPORT ON BANKRUPTCY LAWS, *supra* note 8, at 202 (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.").

49. There is some departure from this principle embedded in the Bankruptcy Code itself, insofar as certain creditors are afforded repayment ahead of others by virtue of their priority status, which is delineated in 11 U.S.C. § 507. For example, domestic support obligations receive first priority in the order of repayment, such that other claims will not receive any repayment until those debts are satisfied. *See id.* § 507(a)(1)(A). In addition, employee wages up to $12,850 receive priority over most other unsecured debts and must be satisfied before those debts are paid. *See id.* § 507(a)(4).

50. *See, e.g.*, Broome, *supra* note 47, at 115 (noting that, after 1978, "the main goal of preference provision was to preserve equality of distribution," with deterrence "only an incidental objective"); Countryman, *supra* note 4, at 748 ("The function of the preference concept is to avoid prebankruptcy transfers that distort the bankruptcy policy of distribution."); McCoid, *supra* note 43, at 260 ("Preference law tries to impose equality on prebankruptcy behavior so that that behavior will not make the principle of equality in bankruptcy distribution meaningless."); 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."); Rafael I. Pardo, *On Proof of Preferential Effect*, 55 ALA. L. REV. 281, 283 (2004); Weisberg, *supra* note 8, 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.").

Published by University of Oklahoma College of Law Digital Commons, 2019

bringing or threatening a lawsuit.[51] In the United States, however, the intentions of both debtor and creditor are irrelevant;[52] it is only the effect of the transfer that matters. Accordingly, a creditor who accepts a payment with no knowledge of the debtor's insolvency may be found liable for a preference, even absent any evidence that the debtor intended to prefer the creditor over others.

Some have argued that, in addition to its function as an equalizer among unsecured creditors, preference law also serves as a deterrent against creditor efforts to sidestep inclusion in the pro rata distribution afforded under the bankruptcy system. However, the actual deterrent effect of preference law is highly suspect.[53] The purported deterrent force of preference law rests on some flawed assumptions that simply are not reflected in real-world experience. As explained by Lawrence Ponoroff, the belief appears to be that:

> without a preference law, creditors that supposedly might otherwise have been inclined to work with the debtor will feel obliged to swoop in to claim their share of the available spoils as soon [sic] they learn that the debtor has come upon financially-troubled waters. Thus, the debtor's slide into bankruptcy will become inevitable. But, with the existence of preference liability, the reasoning goes, any such efforts will be futile, so that the creditors will say, "shucks, no point if I'm just going to have to give it back."[54]

In my research, creditors usually do not make such a pre-calculation, because they are unaware of preference law or because they consider preference litigation to be a remote possibility. Even when creditors do anticipate preference liability, they typically use cost/benefit analysis to determine that they will be better off collecting now, risking the possibility of repaying some part of what they collected later.[55] This is not to say that

---

51. *See* Adrian Walters, *Preferences*, *in* VULNERABLE TRANSACTIONS IN CORPORATE INSOLVENCY 123 (John Armour & Howard Bennett eds., 2003).

52. *See* H.R. REP. NO. 95-595, at 178, *as reprinted in* 1978 U.S.C.C.A.N. at 6138 (discussing the reasons for doing away with the requirement that a creditor be aware of the debtor's insolvency).

53. Gotberg, *supra* note 31, at 613; Tabb, *supra* note 47, at 990 ("Deterrence is effective, however, only against parties who are aware of the debtor's financial distress and who therefore see the collective proceeding coming. Innocent parties by definition will not be deterred; the state of the preference law will have no impact on their behavior.").

54. Lawrence Ponoroff, *Bankruptcy Preferences: Recalcitrant Passengers Aboard the Flight from Creditor Equality*, 90 AM. BANKR. L.J. 329, 344 (2016).

55. *See* Gotberg, *supra* note 31, at 611-12.

preference law does not affect creditor behavior, but it does not do so in ways that are particularly beneficial to the debtor.[56] Further, creditors are consistently advised by their attorneys to take preferential payments when they are offered.[57] Accordingly, it is unclear what deterrent effect preference laws have. This leaves the enforcement of equality principles as the primary remaining goal identified in the legislative history. As explained below, chapter 11 preference avoidance actions serve neither of the rationales given in the legislative history, but instead promote an entirely different policy goal. Put simply, in chapter 11 the availability of preference avoidance actions increases a debtor's leverage over creditors.

II. Trade Creditors and Bankruptcy Proceedings

A. Introducing Trade Creditors

Technically, any creditor who has received a transfer from the debtor in the ninety-day preference period may be subject to a preference action.[58] However, liable parties are most frequently unsecured creditors, for the simple reason that preference actions are only available when the targeted transfer allows the creditor to receive more than it would have had the transfer not been made and property distributed pursuant to chapter 7 principles.[59] Secured creditors are generally immune from preference liability, because they are paid in full up to the amount of their collateral, even in bankruptcy proceedings.[60] In contrast, unsecured creditors rarely receive 100% of their claims in bankruptcy, such that any transfer in the preference period will serve to improve their position under preference laws.[61] The population of unsecured creditors in small- and medium-sized chapter 11 cases is largely made of up of so-called trade creditors.[62]

---

56. *See* Ponoroff, *supra* note 55, at 345 ("Of course, overlooked in this simplistic and rosy picture of creditor behavior is the fact that the existence of a preference law might just as easily motivate a creditor, otherwise inclined to work with the debtor, to race to the courthouse and grab the debtor's remaining assets with the hope not only of getting ahead of its fellow creditors, but also of getting ahead of the ninety-day clock.").

57. *See* Gotberg, *supra* note 31, at 610-11.

58. 11 U.S.C. § 547(b) (2018).

59. *See id.* § 547(b)(5).

60. *See id.* § 506(a).

61. *See* Countryman, *supra* note 4, at 736-37.

62. Although they also appear in large chapter 11 cases, trade creditors are treated differently depending on the size of the case. *See* Douglas Baird, Arturo Bris & Ning Zhu, *The Dynamics of Large and Small Chapter 11 Cases: An Empirical Study* (Yale Int'l Ctr. for Fin.,

Published by University of Oklahoma College of Law Digital Commons, 2019

Although the term "trade creditor" does not appear in the Bankruptcy Code and is not subject to a universal definition, it is generally understood to embody those unsecured creditors who have been engaged in business transactions with the debtor on the basis of short-term credit.[63] Trade creditors may or may not have signed a formal contract with the debtor, and they may have short- or long-term relationships with the debtor. The exchanges between trade creditors and debtors are presumptively unsecured, because the parties tend to be engaged in transactions in which the grant of a security interest would be impractical. This is perhaps due to the small size or informal nature of the transactions.[64] However, some trade creditors may be able to obtain liens (such as mechanics' liens) or other possessory interests in the debtor's assets.[65]

Trade creditors are frequently overlooked in discussions of bankruptcy policy, perhaps because their importance is overshadowed by the influence of other parties, such as a post-petition financier[66] or a pre-petition secured creditor with an interest in essential collateral.[67] Although unsecured trade creditors do not have an interest in collateral held by the debtor, they nevertheless control an asset in which the debtor is invested—the future goods and services of the creditor, to which the debtor has often become accustomed and which may be vital to the smooth operation of the debtor's business. In this regard, some trade creditors may be more essential than

---

Working Paper No. 05-29, 2007), https://perma.cc/EUW8-GDXD ("Small businesses in Chapter 11 (and the vast majority are small) are qualitatively different from larger ones.").

63. *See* DON B. BRADLEY, III & MICHAEL J. RUBACH, TRADE CREDIT AND SMALL BUSINESSES: A CASE OF BUSINESS FAILURES 1 (2002), http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.508.7600&rep=rep1&type=pdf.

64. For other insights on how and why trade credit is used, see Mariassunta Giannetti et al., *What You Sell Is What You Lend?: Explaining Trade Credit Contracts*, 24 REV. FIN. STUD. 1261, 1262 (2008).

65. *See* Stephen J. Lubben, *Some Realism About Reorganization: Explaining the Failure of Chapter 11 Theory*, 106 DICK. L. REV. 267, 295 (2001).

66. *See* Telephone Interview with CA (May 25, 2017) ("[Y]ou can't go into bankruptcy without having cash flow or . . . a financing friend.").

67. *See* Charles J. Tabb, *Credit Bidding, Security, and the Obsolescence of Chapter 11*, 2013 U. ILL. L. REV. 103, 142 ("Today, senior secured debt rules."). The importance of a secured creditor is due in large part to the ability of such a creditor to influence the bankruptcy case by virtue of the leverage it holds on the debtor's collateral. *See* Stuart C. Gilson & Michael R. Vetsuypens, *Creditor Control in Financially Distressed Firms: Empirical Evidence*, 72 WASH. U. L.Q. 1005, 1011-12 (1994) (reporting on a study analyzing 381 publicly held firms that experience severe stock price declines, which found a 52% likelihood of management turnover, often accredited to the pressure of banks, with more senior and secured claims exercising a greater weight of influence).

https://digitalcommons.law.ou.edu/olr/vol71/iss4/3

others, depending on the importance of the trade creditor's business to the function of the debtor's, the availability of alternatives, and other similar factors. In the example given above,[68] Owen's Ovens provides a specialized service and is the only provider of molded fiber ovens in Debtor Daniels' area. On the other hand, Patty's Paper Pulp is a more generic product for which alternatives and additional vendors are readily available. In some cases, creditors and debtors may become mutually reliant on each other by virtue of co-specialization, each having adjusted their business to the use of the other's product.[69] Generally speaking, the more specialized, unique, or difficult it is to obtain a good or service, and the more essential it is to the debtor's operations, the more important it is to maintain good relations with the provider of that good or service and to secure his or her cooperation in the bankruptcy proceedings.[70]

B. Trade Creditors' Influence in Bankruptcy Proceedings

If trade creditors respond to a bankruptcy filing by refusing to do business with the debtor in the future, then reorganization is likely to be impossible; without the goods and services necessary to run the business, the debtor will simply be unable to continue operations. Absent a pre-existing contractual relationship,[71] the Bankruptcy Code contains no obligation that creditors continue to do business with a debtor after a bankruptcy filing, even on a cash basis.[72] Moreover, there is no obligation that a creditor provide post-petition

---

68. *See* discussion *supra* notes 18-19.

69. *See* Charles J. Goetz & Robert E. Scott, *Principles of Relational Contracts*, 67 VA. L. REV. 1089, 1101 (1981) ("The essence of the problem is that, even where perfectly substitutable trading parties are initially available in a competitive market, the increasing specialization of the parties vis-a-vis each other produces a species of bilateral monopoly.").

70. *See* Telephone Interview with DA (Aug. 31, 2017) (noting that, prior to filing, debtor's counsel must consult with the client regarding what the vendor reaction is likely to be, and that such reaction varies depending on how unique or replaceable the vendor's goods are).

71. Creditors who breach a contract with the debtor will be liable for damages associated with breach. Likewise, a debtor may be liable if it breaches a contract with a creditor; however, the breach will be treated as a pre-bankruptcy obligation and paid out pursuant to the chapter 11 plan. This usually means that the unsecured debt incurred by the breach will be significantly reduced, as it will be paid out on a pro rata basis with all other unsecured debt. *See generally* 11 U.S.C. § 365 (2018).

72. *But see id.* § 525 (establishing protections against discriminatory treatment by governmental units or private employers solely because a debtor filed for bankruptcy).

Published by University of Oklahoma College of Law Digital Commons, 2019

trade credit to a debtor, which may be sorely needed in light of cash constraints.[73]

Debtors in chapter 11 frequently have a strong incentive to placate trade creditors in order to ensure ongoing business relationships and a positive vote on the chapter 11 Plan. Locating a replacement source of goods and services, even if it can be done, will almost always require time and energy on the part of the debtor, and the terms offered post-bankruptcy are rarely more favorable than the terms obtained pre-bankruptcy.[74] In addition, although individual trade creditors typically lack the voting power of secured creditors,[75] as a group they can influence the outcome of the case by choosing to support or reject a DIP's plan of reorganization.[76]

As with any other group of creditors, the DIP depends on the cooperation of trade creditors to vote in favor of a bankruptcy plan in order to ensure confirmation by the court.[77] In situations where the DIP faces an uncooperative secured creditor, votes from trade creditors may be particularly vital in order to ensure a "cramdown" plan.[78] In the event that a

---

73. *See* Robert I. Sutton & Anita L. Callahan, *The Stigma of Bankruptcy: Spoiled Organizational Image and Its Management*, 30 ACAD. MGMT. J. 405, 417 (1987) ("[I]ndividuals or organizations that participate in relationships with bankrupt firms can often negotiate more favorable terms of exchange than previously existed; the fact of Chapter 11 increases their bargaining power."); Telephone Interview with DA (May 25, 2017) ("[I]t's very difficult for any business to stay in business if they can't get at least 30-day credit, 30 to 60."); discussion *infra* note 129.

74. *See* Lubben, *supra* note 65, at 296 ("[I]t is hard to envision any system of reorganization functioning without a means to ensure the cooperation of at least a core group of the debtor's suppliers.").

75. Any individual secured creditor has the power to make a Plan nonconsensual by voting against it, because consensual plans require the approval of all classes, and secured creditors are typically a class in and of themselves. *See* 11 U.S.C. § 1122 (2018); Jack Friedman, *What Courts Do to Secured Creditors in Chapter 11 Cram Down*, 14 CARDOZO L. REV. 1495, 1500 (1992) ("The general rule . . . is that each secured claim is almost always placed in its own separate class because each has different rights regarding collateral and priority.").

76. Trade creditors can be, and typically are, lumped into a single class. *See* 11 U.S.C. § 1122. A class is considered to have accepted the plan of reorganization if at least two-thirds of the class, measured by the combined amount of their claims, and more than one-half of the number of creditors have accepted the plan. *Id.* § 1126(c).

77. *See id.* § 1129(a)(8) (requiring that each impaired class of claims has accepted the plan).

78. *See id.* § 1129(b). Although the term "cramdown" does not appear in the Code, it is common parlance for the alternative path to plan confirmation that involves the consent of only one class of creditors. A cramdown plan involves additional oversight by the court and adherence to additional requirements. These requirements include obtaining a court

https://digitalcommons.law.ou.edu/olr/vol71/iss4/3

secured creditor is undersecured and bifurcates its claim into secured and unsecured classes,[79] trade creditor support may be even more vital in order to outweigh the undersecured creditor's veto, especially if there is only one class of unsecured creditors.[80] The influence that any individual trade creditor will have on the acceptance of the plan will depend largely on how creditors are classified and the size of the classes, in addition to the size of the individual creditor's claim.

Beyond the vote, trade creditors may have an impact on the chapter 11 case by virtue of being part of a creditor's committee, which may be formed by the United States trustee to oversee the proceedings and raise issues with the court as needed.[81] Such a committee is typically formed by the holders of the largest unsecured claims against the debtor,[82] which frequently will include some number of trade creditors. The committee is entitled to appoint an attorney or another professional representative (such as an accountant) to oversee its interests and investigate the DIP.[83] The representative will be paid, not by the trade creditors directly, but rather from bankruptcy estate

---

determination that the plan does not discriminate unfairly, but is instead fair and equitable with respect to each class of claims or interests impaired under the plan. Perhaps the most difficult of these requirements is that the plan "be fair and equitable," which is defined in the Code as requiring all junior interest holders to forfeit their interests in the debtor unless and until more senior interest holders have been satisfied in full. *See id.* § 1129(b)(2). This "absolute priority" rule can mean that a debtor's principals must sacrifice their equity in order to confirm a plan, which is often a tenuous result, especially for closely-held organizations. *See* CHARLES JORDAN TABB, THE LAW OF BANKRUPTCY 1182-83 (4th ed. 2016). A potential escape hatch for equity holders is the "new value corollary" to the absolute priority rule, which could allow former equity holders to repurchase their equity by virtue of a fresh infusion of value through the chapter 11 plan. Although the contribution of new value in exchange for old equity is not explicitly permitted in the Bankruptcy Code, it has been implicitly recognized by the Supreme Court in *Bank of America National Trust & Savings Ass'n v. 203 North Lasalle Street Partnership*, 526 U.S. 434, 449 (1999).

79. An undersecured creditor may—but is not required to—avoid bifurcation by electing to treat the entire undersecured claim as fully secured. In doing so, the creditor forfeits the right to the present value of its claim and accepts a nominal dollar amount (usually paid out over time) instead. This is commonly called the "§1111(b) election." *See* 11 U.S.C. § 1111(b)(2).

80. There is some uncertainty in the law over whether a debtor can classify the unsecured portion of a secured creditor's claim separately in order to establish a consenting class in a cramdown situation. *See* Linda J. Rusch, *Gerrymandering the Classification Issue in Chapter Eleven Reorganizations*, 63 U. COLO. L. REV. 163, 164 (1992).

81. *See* 11 U.S.C. § 1102(a).

82. *See id.* § 1102(b).

83. *See id.* § 1103(a), (c).

Published by University of Oklahoma College of Law Digital Commons, 2019

assets as an administrative expense.[84] The appointment of such a committee thus imposes an additional level of pressure on the DIP to acknowledge concerns held by the unsecured creditors represented by the creditors' committee, both because the committee has the ability to demand information from the DIP and to file motions with the bankruptcy court, and because work performed by the committee will be at the expense of the debtor's estate. A cooperative committee can facilitate the reorganization process; an uncooperative committee can introduce significant time delays and added expense to the process.[85]

Finally, the cooperation of trade creditors can be a meaningful signal to other important players about the viability of the debtor over the long term. Potential financiers of the debtor may look to the willingness of trade creditors to extend short-term credit to the debtor in evaluating whether they are willing to invest for longer periods of time.[86] Courts may look to the expressed willingness of trade creditors to continue in business with the debtor as a signal that a plan of reorganization is feasible.[87] Ultimately, trade creditors have a significant role to play in the success of a debtor's reorganization that should not be overlooked or understated.[88]

---

84. *See id.* § 503(b)(4).

85. *See* Telephone Interview with CA (May 25, 2017) ("[A] lot of the debtors consider it just more cost and interference. But, I think a sophisticated debtor attorney doesn't really mind a committee of truly unsecured trade creditors because at the end of the day you want that class to accept. And, that can be your vehicle to try to get the acceptance."); Telephone Interview with DA (June 20, 2017) ("You want them to work with you, because Chapter 11 is a collaborative process . . . . Most cases that I've experienced where you have a lot of creditor animosity will not be successful because the debtor will spend too much time and money fighting as opposed to focusing on restructuring. So, without a collaborative effort the successful Chapter 11 process I think is hindered substantially.").

86. *See* Lubben, *supra* note 65, at 295.

87. *See* 11 U.S.C. § 1129(a)(11) (requiring that the court find that "[c]onfirmation of [a] chapter 11 plan is not likely to be followed by [a] liquidation, or [a] need for further financial reorganization").

88. *See* Lubben, *supra* note 65, at 294 ("The trade creditor . . . is one of the most neglected and misunderstood parties in Chapter 11 theory."). That said, it is a common perception among attorneys that, of the three groups, trade creditors are typically the most insignificant in a bankruptcy case. *See* Telephone Interview with DA (May 25, 2017); Telephone Interview with DA (June 6, 2017) ("[R]ealistically, trade creditors, except for the ones that you have to have, the critical vendors, they have no leverage. You just ignore them."); Telephone Interview with CA (June 21, 2017) ("[M]y experience is that unless they're on a committee then you don't really care much from trade.").

C. Trade Creditors as a Study Group

I decided to focus my research on preference actions against trade creditors in the bankruptcies of small- and medium-sized companies for both practical and substantive reasons. On the practical side, I was concerned that it would prove difficult to arrange interviews with individuals at larger institutions who would be both willing to speak with me and able to provide meaningful insight regarding how company decisionmakers reacted to a bankruptcy filing or a preference lawsuit. Further, I assumed that small- and medium-sized companies were more likely to be affected by an individual bankruptcy filing or preference lawsuit, and would therefore be a more likely source for feedback.[89] Substantively, it made more sense to focus on the use of preference actions in small- and medium-sized cases because they represent the bulk of chapter 11 filings; although they are processed in the same chapter as mega-cases, they function very differently in practice.[90] Similarly, I wanted to focus on the impact of preference actions on parties most likely to be targeted by such actions, which in these smaller cases were unsecured trade creditors. Although there are interesting insights to be gleaned from studies of other types of creditors in chapter 11,[91] and I freely acknowledge that such insights are not included in these results, considerations of scope made it necessary to limit my findings to this group.

I also consciously limited my study to chapter 11 cases in which a plan of reorganization had been successfully confirmed. Many filed chapter 11 cases do not result in a confirmed plan, and are instead dismissed or converted to a chapter 7 case, in which liquidation is the only possible outcome.[92]

---

89. *See* Michael J. Peel, Nicholas Wilson & Carole Howorth, *Late Payment and Credit Management in the Small Firm Sector: Some Empirical Evidence*, INT'L SMALL BUS. J., Jan. 2000, at 17, 18 (noting the problems caused by late payment or nonpayment of credit for smaller firms in the UK).

90. *See* Baird, Bris & Zhu, *supra* note 62; Leif M. Clark, *Chapter 11 – Does One Size Fit All?*, 4 AM. BANKR. INST. L. REV. 167, 168 (1996) (questioning whether chapter 11 is elastic enough to accommodate the different entities filing under it); George W. Kuney, *ABI Commission Testimony: November 7, 2013*, 15 TENN. J. BUS. L. 333, 334 (2014) (arguing for revision of the Bankruptcy Code to allow for different treatment for small businesses).

91. For example, the interactions between debtors and lenders is a worthy area of study. *See, e.g.*, Ronald J. Mann, *Strategy and Force in the Liquidation of Secured Debt*, 96 MICH. L. REV. 159 (1997).

92. A study of chapter 11 cases filed between 1989 and 1995 indicated that "35.3 percent of the cases were dismissed and 35.4 percent were converted [to chapter 7]." *See* Ed Flynn & Gordon Bermont, *Outcomes of Chapter 11 Cases U.S. Trustee Database Sheds New Light on Old Questions*, AM. BANKR. INST. (Feb. 1, 1998), https://www.abi.org/abi-journal/outcomes-of-chapter-11-cases-us-trustee-database-sheds-new-light-on-old-questions; Stephen J.

Published by University of Oklahoma College of Law Digital Commons, 2019

Furthermore, a significant portion of confirmed plans result in the liquidation of the filing debtor.[93] In deciding to focus only on reorganized cases, I noted that preliminary inquiries had suggested that the treatment of preferential transfers was significantly different between cases of liquidation and reorganization, as explained in greater depth below.[94] The simple reason for this distinction was that in liquidation cases, neither party was concerned with the effect of its actions on the business relationship, as the business relationship would necessarily end. Furthermore, in liquidation cases, parties besides the debtor were typically responsible for deciding whether, when, and how to bring preference actions.[95] Accordingly, this analysis applies only in the context of reorganization, and may not (indeed, is unlikely to) hold in liquidation scenarios.

I further narrowed the scope of my potential pool of interviewees by only contacting individuals in cases in which a preference action had been filed, reflective of my particular interest in how preference actions were being used and how they impacted trade creditors. Accordingly, my study was not, and was not intended to be, reflective of the entire population of scenarios, or even representative of cases that are filed. Instead, I sought out information from parties in circumstances that were more relevant to my underlying interest, which was how preferences impact a trade creditor's ongoing business relationship with a debtor. However, in interviews with attorneys or credit managers, these repeat players often referenced or compared their experiences in chapter 11 to what they had seen in liquidation cases, large cases, cases with lenders, or other circumstances not targeted for study.

Finally, I looked to cases that had been closed sometime in the previous five years. I reasoned that, in limiting the scope of my research temporally, I would be more likely to encounter businesses that were still in existence and the subjects I contacted would be more likely to clearly remember the

---

Lubben, *Business Liquidations* 81 AM. BANKR. L.J. 65, 66-68 (2007) ("Very few creditors ultimately receive the benefits of a chapter 11 liquidation – most chapter 11 cases convert to chapter 7 and very few liquidating plans are ultimately confirmed.").

93. *See* Susan Jensen-Conklin, *Do Confirmed Chapter 11 Plans Consummate? The Results of a Study and Analysis of the Law*, 97 COM. L.J. 297, 319 (1992) ("Of the 42 cases in which the nature of the confirmed plan could be determined in the Poughkeepsie Study, 11 were liquidating plans or about 26 percent. Similarly, the Flynn Study estimated that approximately 25 percent of the confirmed cases had liquidating plans."); Elizabeth Warren & Jay Lawrence Westbrook, *The Success of Chapter 11: A Challenge to the Critics*, 107 MICH. L. REV. 603, 641 (2009) (noting that less than 21% of confirmed Chapter 11 plans to be liquidating plans).

94. *See* discussion *infra* note 212.

95. *See* discussion *infra* note 214.

https://digitalcommons.law.ou.edu/olr/vol71/iss4/3

bankruptcy. I discovered that, even with this precaution, there were inevitably subjects who had gone out of business or changed locations by the time I attempted to contact them. In addition, I encountered individual representatives of companies named in bankruptcy filings who had not themselves been involved in the bankruptcy proceedings, often because they joined the company after the bankruptcy filing had taken place.

In order to identify possible subjects, I used the Bloomberg Law search engine to pull public bankruptcy records for all chapter 11 cases with a confirmed plan that closed sometime between August 30, 2010 and February 1, 2017. I limited my search to companies with assets and liabilities in the range of $1 million to $100 million that also listed unsecured trade creditors in their schedules. Within the bankruptcy cases that fit these size and date requirements, I looked for debtors that had filed a preference action against a creditor, searching within court documents for any reference to § 547 (the Bankruptcy Code section for preference avoidance).[96] This group became my base sample.

For each of the cases within my sample, I identified the top twenty unsecured creditors, as listed by the debtor on Official Form 4. I further identified any additional creditors who were the subject of a preference lawsuit, as reflected in the court record. Beginning with the five most recent cases, and then taking one case at a time from the base sample group in alphabetical order, I contacted these creditors, the debtor, and all the attorneys who had entered an appearance in the case.[97] Because I was primarily interested in actions against trade creditors, I excluded taxing

96. The Bankruptcy Code allows for actions similar to preference avoidance in other sections, which target specific behavior. *See, e.g.*, 11 U.S.C. § 553(b)(1) (2018) (allowing the trustee to recover the amount set off by a creditor in the ninety days before bankruptcy on a preference-like analysis). However, I did not target these provisions for consideration in my study.

97. I began by sending introductory letters to individuals whose contact information was listed in association with the creditors, debtors, and attorneys in my study. A copy of the letter is attached as Appendix D. I continued to contact individuals associated with cases in the base sample, beginning with the five most recent cases and then proceeding in alphabetical order, until I had sent mailings to approximately 350 individuals. A few weeks after mailing the letters, I attempted to call the individual creditors, debtors, and attorneys for whom I could locate telephone numbers. Some individuals responded to my letter with requests not to be contacted. For others, the introductory letter was returned as undeliverable. In these cases, I did not make further attempts to contact the parties. If I was successful in reaching an individual I made the request to interview him or her for this study. In many cases, I left messages on voicemail or with an assistant. Where I left messages, I attempted a second phone call before abandoning the contact.

Published by University of Oklahoma College of Law Digital Commons, 2019

entities, insiders, creditors subject to an action under § 544,[98] and judgment creditors.[99] Finally, due to language constraints and concerns regarding communication costs, I excluded all creditors located outside the United States.

Through these efforts, I was able to obtain complete interviews from forty-eight individuals,[100] including twenty-eight creditors, three debtors,[101] and seventeen attorneys.[102] These individuals were drawn from a total of twelve bankruptcy cases. Of the attorneys, ten identified primarily as debtors'

98. These would typically be creditors who had not perfected their otherwise valid security interests prior to the bankruptcy filing. Pursuant to 11 U.S.C. § 544, a bankruptcy trustee is afforded all the rights of a hypothetical lien creditor who obtained a judicial lien over all of the debtor's property as of the commencement of the case. Pursuant to the rules of secured transactions, as reflected in UCC § 9-317(a), the bankruptcy trustee would prevail over any secured creditor not perfected as of the date of filing.

99. The exclusion of judgment creditors was due primarily to my desire to focus on how bankruptcy filings and preference actions affected business relationships between debtors and creditors. When creditors were identified as judgment creditors, it appeared to distinguish them from creditors who were or had been engaged in ongoing business dealings with the debtor ("trade creditors"). I did not deliberately exclude trade creditors who had obtained a judgment against the debtor prior to the bankruptcy filing.

100. Sampling for a qualitative research project is not necessarily a straightforward endeavor, and there is some difference of opinion regarding the number of observations that are sufficient to draw conclusions. However, the accepted literature indicates that this sample size is within the range generally considered acceptable for a qualitative study. *See* Mark Mason, *Sample Size and Saturation in PhD Studies Using Qualitative Interviews*, FORUM: QUALITATIVE SOC. RES., Sept. 2010, at 3, 10-13 (2010) (citing research suggesting that twenty-five to fifty participants are adequate, and that little "new" comes of out transcripts after twenty interviews).

101. The ratio of debtor to creditor interviews largely reflects the overall ratio within cases. Obviously, each individual debtor had multiple creditors. In addition, I found it difficult to locate debtors to interview, as the individuals involved during a bankruptcy case were frequently no longer associated with the company, their contact information had changed, or they simply did not care to speak with me regarding their experiences. In several cases, although the business continued as a going concern following chapter 11, it was through a sale of substantially all assets to a new buyer, making the contact information listed in court filings utterly obsolete. Accordingly, my findings are significantly skewed with regards to the experience of creditors, although there is some insight to be had from the interviews I conducted with debtors' attorneys, who often reported on the reactions they received in advising debtors on bankruptcy and preference actions.

102. One attorney interviewed was referred to me by another study participant and so was not contacted by virtue of his involvement in one of the sample cases. This attorney was referred to me as someone particularly experienced in preference actions for mid-sized companies. As explained below, because all attorneys spoke generally regarding their overall experiences rather than providing specifics for a given case, participation in a case within the sample was not essential.

https://digitalcommons.law.ou.edu/olr/vol71/iss4/3

counsel. The remaining seven primarily represented creditors, although virtually all attorneys had some experience working with both debtor and creditor clients. Combined, the attorneys represented over 515 years of experience. Among creditors, the size of the company with which individuals were associated varied widely. Some creditors interviewed were sole practitioners or "mom and pop" shops, while others were associated with large international organizations. Interviewees self-identified as owners, part-owners, CFOs, and credit managers of their companies. They represented a diverse population geographically, hailing from eighteen different states including New York, Florida, and California as well as Kansas, Michigan, and North Dakota.

All interviews were conducted in a five-month period, between May 18, 2017 and October 18, 2017. Interviews lasted anywhere from ten minutes to over an hour, with most falling in the range of fifteen- to twenty-minute conversations. A discussion of the findings from these interviews follows.

III. Bankruptcy and Business Relationships

A. Study Findings

In my interviews with trade creditors, I followed a set script that asked some preliminary questions regarding the creditor's size and type of business. The script then asked about the creditor's pre-bankruptcy relationship with the debtor and then the creditor's reaction upon receiving news of the debtor's bankruptcy. It then inquired whether the creditor continued to do business with the debtor after the bankruptcy filing. For creditors that had been the subject of a preference action, the script asked about the creditor's reactions upon learning of the preference demand, as well as how the creditor ultimately responded to the preference demand. Throughout, creditors were invited to share their thoughts on the bankruptcy proceedings and if there were ways in which the experience could have been better.[103]

In addition to interviewing creditors, I also interviewed some debtors. I was less successful in locating debtors willing to be interviewed, but the debtors who participated in the study spoke about their experiences, how their relationships with creditors did or did not change as a result of the filing, and how they had made decisions regarding whether to bring preference actions.[104]

---

103. A copy of the interview script used is attached as Appendix A.

104. A copy of the interview script used with debtors is attached as Appendix B.

Published by University of Oklahoma College of Law Digital Commons, 2019

Finally, I included in the study a large number of attorneys who represented both debtors and creditors in the bankruptcy proceedings. In order to avoid violating confidentiality or imposing upon attorney-client privilege, I asked attorneys to give their general thoughts on how debtors and creditors navigated the bankruptcy process, and more specifically how the decision to pursue a preference was made. I also asked questions regarding their perceptions on how bankruptcy and preference actions influenced business relationships between debtors and creditors.[105]

Most of the creditors and creditors' attorneys I interviewed indicated that, in cases where a business partner had filed for bankruptcy, creditors were inclined to continue to do business with the debtor, provided there was certainty in receiving payment going forward. To some extent, however, this was informed by the nature of the business relationship prior to the bankruptcy and the behavior of the debtor within the bankruptcy proceedings. Creditors were particularly sensitive to the perceived reasons for the bankruptcy filing in the first place, including whether it stemmed from external influences or the debtor's individual trustworthiness. Creditors also commented on the credit terms that the debtor would be afforded, demonstrating some inclination to tighten credit post-bankruptcy but usually not to withhold credit altogether. These findings are explained in more detail below.

1. Forward-Looking Profits

Participants interviewed in this study largely expressed the sentiment that future profits were more important than past losses and were therefore a greater influence on decision-making. As expressed by one creditor:

> [G]etting our product on the shelf is way more important than the debt. So, we kind of overlook a lot of those things and we work with our customers because we don't want to lose that shelf space, and we don't want to lose any cooler space, so we really make sure that our customers are a priority for us.[106]

Another creditor noted,

> I think we still have a good relationship with the managers, with the company. . . . [T]he name was changed and the whole structure changed but the projects we were working on were still viable

105. A copy of the interview script used for both debtors' and creditors' attorneys is attached as Appendix C.

106. Telephone Interview with C (May 18, 2017).

https://digitalcommons.law.ou.edu/olr/vol71/iss4/3

> projects and we continued to do work on them. It didn't end our relationship because we didn't get paid, it just hampered it. . . . [Y]ou never want to give up on a client that you have had some success in helping them and they want to continue utilizing your services, so, the bankruptcy is kind of rough waters, not necessarily ending of the relationship.[107]

Other creditors also reported making decisions based on the opportunity to preserve the business going forward. As one put it, "we're in the business to make money," and doing business going forward often presented an opportunity to make a profit.[108] Court oversight of a DIP proved to be a reassuring influence for some. As one credit manager observed,

> If you continue to go forward[, i]t's actually better to sell to a company when they're [a] debtor in possession, th[a]n when they're not because they have a court order allowing them to continue as a debtor in possession[. T]hey have to pay those bills.[109]

Attorneys observed that creditors were likely to take a bankruptcy filing in stride as an inevitable risk to be managed,[110] and that post-filing business was often desirable as a way of obtaining a profit, which might offset the loss inherent in writing off bankruptcy debt.[111] It was more unusual to see creditors flatly refuse to do business with a debtor after filing,[112] although

---

107. Telephone Interview with C (Oct. 18, 2017).

108. Telephone Interview with C-JC (June 6, 2017); *see also* Telephone Interview with C (July 11, 2017) ("We invested the write-off of our claim, but it's been, you know, we've still maintained a long-term client and they continue to pay us whatever we bill them, at our standard rates. So, it's a good paying, good realization in our world, a good margin for us.").

109. Telephone Interview with C-BC (July 14, 2017).

110. *See* Telephone Interview with DA (June 23, 2017) ("It's usually pretty . . . diplomatic. . . . Nobody's getting really personal on things. . . . It's just kind of business as usual.").

111. *See* Telephone Interview with CA (May 25, 2017) ("I think for the most part, at least our clients, I mean it's not like they get hopping mad about it, I think many of them accept it as a cost of doing business."); Telephone Interview with CA (June 6, 2017) ("Tomorrow's sale is more important than yesterday's payment."); Telephone Interview with DA (July 17, 2017) (observing that trade creditors think about being paid going forward); Telephone Interview with CA (Aug. 8, 2017) (claiming that trade creditors are primarily concerned with not being "stung a second time around"); *see also* Telephone Interview with DA (June 20, 2017) ("[U]sually you end up working together which is why in most cases, by the time you get to the confirmation period, we like to say it's a 'love-fest.'").

112. *See* Telephone Interview with CA (Aug. 8, 2017) ("I think it was exceedingly rare where a supplier would say, 'I just don't want to do business.' That was very rare.");

Published by University of Oklahoma College of Law Digital Commons, 2019

creditor responses could vary depending on various factors, including the sophistication of the creditor and the size of the claim.[113] As explained by one debtor's attorney with over thirty-five years of experience in the field,

> [Y]ou get a really mixed reaction. . . . But, generally I have found that the unsecured creditors tend to work with the company[. Y]ou know, they may get over some initial reluctance, but usually I think their best interest is served by continuing the relationship because they are selling to the debtor[] or providing goods and services on an ongoing basis. And once in the [chapter] 11 the debtor has to pay for them on a current basis[. A]nd on top of that there's a chance for them to get paid something back on the pre-petition claim. So, I haven't found that it's an altogether hostile environment. Although, if there is distrust or there has been a long pre-bankruptcy history between the debtors and the creditors, that can lead to some ill will that you have to overcome during the case.[114]

Despite this consensus, there were multiple creditors within the sample who reported that they would not do business with a debtor following a bankruptcy filing, in many instances referencing the costs associated with the debtor's default or the bankruptcy itself. In several instances, the debtor's failure to pay triggered payment obligations on the part of the creditor that were particularly onerous, as in cases where the creditor represented a facilitator for the transfer of goods.[115] In one particularly dramatic example, the debtor's bankruptcy filing triggered obligations for the creditor that forced the creditor to close its business entirely. A few months after that, the principal of the creditor—who had inherited the company from his father—

Telephone Interview with DA (Sept. 8, 2017) (indicating that a bankruptcy filing impacts business relationships "[n]ot as much as you might expect").

113. *See* Telephone Interview with DA (Sept. 8, 2017).

114. Telephone Interview with DA (May 19, 2017); *see also* Telephone Interview with DA (July 14, 2017) ("[W]hen they find out they're in trouble there's sort of a mixed reaction from the creditors.").

115. *See* Telephone Interview with CA (May 25, 2017) ("[For] the smaller local companies, [bankruptcy] can be a big impact and it can be a significant shock to them."); Telephone Interview with PC-R (Sept. 7, 2017) ("[W]hat we had to do was take $30,000 from our savings and pay these people . . . . So, he paid the suppliers and we just sat and waited, hoping to get the money back from [the debtor]. We never did."); Telephone Interview with PC (Sept. 14, 2017) ("You don't just lose the money that they didn't pay you. You have to dip into your own pocket and pay the land owner and the trucker so that you keep your reputation.").

took his own life.[116] As reported by the creditor's counsel in the bankruptcy proceedings, the forced write-off proved "catastrophic" for the creditor, such that the bankruptcy filing necessarily destroyed the business relationship by destroying the business itself.[117]

Research suggests that this outcome is not altogether uncommon, although perhaps more extreme than the norm in its consequences. At least one study found that 66% of bankrupt businesses responding to a survey about non-payment by trade creditors reported that it was a factor in forcing their own bankruptcy filing.[118] Creditors I interviewed frequently noted the financial impact the bankruptcy and subsequent write-off would have on their company's finances. They also pointed to the costs of monitoring and responding to bankruptcy filings that created financial stress on their own businesses.[119] One reported that the experience felt like "a continued, sort-of death by 1,000 papercuts."[120] Ultimately, some of these creditors were inclined to write off the relationship along with the debt.[121]

Still other creditors reported that the decision to continue in business with a debtor depended on the circumstances.[122] The factors that influenced the decision largely tracked concepts of trust and commitment, consistent with the literature on business relationships.[123] However, for most of the creditors

---

116. Telephone Interview with CA (May 18, 2017).

117. *Id.*

118. *See* BRADLEY & RUBACH, *supra* note 63, at 4.

119. *See, e.g.*, Telephone Interview with C-R (May 22, 2017) ("[W]e thought at the end of the day we would spend more in attorney's fees trying to go after this than we would in actually collecting anything.").

120. Telephone interview with C (Oct. 18, 2017) ("[W]e were a small business and we ended up being, I think, unfairly damaged. . . . [W]e couldn't or wouldn't retain an attorney to try and sift through all of that. So, we were left to the mercy of the decisions of the bankruptcy court and ultimately, we lost about $40,000 worth of services revenues in the bankruptcy."); *see also* Telephone Interview with C-BC (July 14, 2017) ("[T]he general rule of thumb is if they've . . . taken you for a loop in bankruptcy or a loss in bankruptcy, you don't want to get back in there.").

121. *See* Telephone Interview with C (June 6, 2017) ("[G]enerally, we are not interested in continuing to do business with the post-bankruptcy corporation or estate. . . . Let's spend our resources in other directions."); Telephone Interview with PC (July 11, 2017) ("[T]hey have to give me an awfully good reason for me to continue to do business with them.").

122. *See* Telephone Interview with PC (July 11, 2017) ("It's a case-by-case basis here. I worked other places that once they file and you take a loss, there's shut down and that is it, no more nothing. When I came here, there would be a bankruptcy and they would turn right around and do business with them."); Telephone Interview with C-N (May 22, 2017) (describing evaluation that includes credit management company conclusions and credit scores).

123. *See* discussion *infra* notes 155-64.

Published by University of Oklahoma College of Law Digital Commons, 2019

in the sample, the question became not whether to continue doing business with a debtor after bankruptcy but rather on what terms.[124]

A perceived benefit (or at least, a silver lining) to doing business with a debtor post-bankruptcy is that payments from a debtor's estate receive administrative priority.[125] Furthermore, a debtor's finances are carefully monitored by the court throughout the bankruptcy process.[126] However, a significant portion of creditors interviewed indicated that, even if they were willing to do business with a bankrupt debtor, they would be unlikely to extend terms as generous as those given pre-bankruptcy.[127] Many creditors indicated they would insist on a cash on delivery (COD) basis.[128] Debtors also described this change in treatment, with one debtor noting, somewhat wistfully, "Before, you were a customer that they truly valued, and it's a little bit of a shift. They now have the upper hand. They can be a little bit more demanding than what they might have been in the past."[129] Although it was less frequently acknowledged, there was some evidence that creditors would also raise prices for a post-petition debtor as a means of recovering lost profits from pre-bankruptcy sales.[130]

---

124. *See, e.g.*, Telephone Interview with CA (July 26, 2017) ("[A]bsent a showing . . . that this customer cannot be trusted, that the reason they filed in bankruptcy in part was to defraud creditors. There's still trust, notwithstanding their filing bankruptcy. And then we do see that there is an opportunity to preserve the trade relationship notwithstanding the Chapter 11 filing. And a bit to go forward is to then ask the threshold. Can we manage credit risk with continued credit extension with this customer?").

125. *See supra* note 51.

126. *See* 11 U.S.C. § 1106 (2018).

127. *See* Telephone Interview with CA (July 26, 2017) ("What we often see is even with that, that assurance so to speak, and the priority, that may not be enough to result in the supplier electing to provide terms to the customer going forward.").

128. *See* Telephone Interview with C (May 18, 2017); Telephone Interview with C-JO (June 6, 2017) ("They can have an account, but they'll probably have to pay as they go."); Telephone Interview with C-VK (June 6, 2017); Telephone Interview with C (July 11, 2017) (requiring payments, if not on a COD basis, monthly); Telephone Interview with PC (July 11, 2017); Telephone Interview with C (Aug. 28, 2017); Telephone Interview with C (Oct. 11, 2017); Telephone Interview with C (Oct. 18, 2017); *see also* Telephone Interview with CA (June 6, 2017) (observing that a pay upon delivery arrangement is "fairly customary" for trade creditors following a bankruptcy).

129. Telephone Interview with D (June 22, 2017); *see also* Telephone Interview with C (Oct. 11, 2017) (noting that the company, although now a creditor, had filed for bankruptcy previously and that "[it was] cash-in-advance until [it] got investment in capital in the business to make people feel comfortable in extending terms again").

130. *See* Telephone Interview with D (June 22, 2017) (observing that some trade creditors insisted on critical vendor status and subsequently charged a premium in addition to demanding cash on delivery); Telephone Interview with PC (July 11, 2017) ("Of course, when

https://digitalcommons.law.ou.edu/olr/vol71/iss4/3

In summary, the consensus among those I interviewed appeared to be that creditors were likely to continue doing business with a bankrupt debtor, so long as the bankruptcy did not mean the liquidation of either party. Creditors were usually inclined to continue providing goods and services because the ongoing business would provide profits that could, at least in part, offset the losses inherent in the write-off of bad debt. However, creditors were not likely to continue doing business with debtors on the same terms as had been enjoyed prior to the bankruptcy; rather, debtors would likely need to provide cash on delivery. As explained below, however, these general principles were influenced by the particularities of debtor behavior, both before and during the bankruptcy proceedings.

2. Influence of Behavior and Trust Prior to and During Bankruptcy Proceedings

Despite the consensus that it usually makes sense for a creditor to continue doing business with a debtor following bankruptcy (particularly on a cash basis), interviewees reported some nuance and distinction in how a creditor reacts to a debtor in a given situation. Creditors and attorneys were quick to reference different factors that could make a difference in the level of a trade creditor's cooperation, both in the decision to continue doing business and in the generosity of terms going forward. By far the two most frequently referenced factors were communication and honesty regarding the situation, both of which seemed to contribute to the creditor's ability to further trust the debtor.

Attorneys—especially debtors' attorneys—seemed particularly attuned to the need for a debtor to appear forthcoming, honest, and transparent in order to encourage greater cooperation among creditors. As one attorney noted, "Your most important asset . . . in any [c]hapter 11 reorganization is the confidence of the creditors, the secured lenders, and that kind of thing. If the vendors, secured lenders, banks think you're a crook, you're done."[131] Attorneys frequently advised debtors to communicate with their creditors

---

[bankruptcy] happens there are opportunities to try and make your money back that you lost. I mean if anybody is really being honest with you, they're going to say that."); Telephone Interview with DA (Aug. 31, 2017) ("I guess maybe a more cynical view is it's an effort to recoup some pre-petition receivable . . . .").

131. Telephone Interview with DA (July 17, 2017); *see also Telephone* Interview with CA (June 21, 2017) ("[I]f they feel cheated they might want to be severing their relationship."); Telephone Interview with DA (Aug. 31, 2017) ("In general, my experience has been that if the company or the debtor, has been generally forthcoming in its situation . . . and approaches the bankruptcy filing in kind of a direct, relatively honest way, in my experience trade creditors have not reacted negatively, have tended to be supportive.").

Published by University of Oklahoma College of Law Digital Commons, 2019

directly. As one observed, "You need to maintain your relationship with your creditors as best you can. You know, it's kind of like, hiding doesn't do you any good. . . . [S]o you're better off talking to them, trying to explain to them what's going on . . . ."[132] Another noted,

> I always encourage the debtor, particularly the smaller business, the small-to-midsize business, to have direct communications with the key creditors and the key vendors, explain why they're there. There could be many reasons why you ended up in chapter 11, that it's not about their desire not to pay this particular creditor and work businessperson to businessperson through it. Be as up front as possible[.] . . . [T]he more information you can give creditors about what's happening, what your timeline is, what your expectations are the happier they are, the more willing they are to work with you.[133]

At times, attorneys recommended that clients communicate with creditors even in advance of filing, although many were also careful to point out that there could be strategic reasons to wait until just after the time of filing.[134] The importance of reaching out and the perceived need for timeliness in communication were more pronounced the more important or valuable the relationship was perceived to be.[135]

Interviews with creditors and their attorneys reinforced the wisdom of this counsel. As one creditor with a relatively short history of transactions with the debtor prior to bankruptcy admitted,

132. Telephone Interview with DA (May 25, 2017).

133. Telephone Interview with DA (June 20, 2017); *see also* Telephone Interview with DA (May 19, 2017) ("[I]t's talking to them, letting them know what the problem is or what it was, what created the problem, what were the issues. And a lot of times it's communication and just trying to break down some of the barriers. Because, most of the time the unsecured creditors really don't know what unique problems the debtor is facing and causing the problem.").

134. *See* Telephone Interview with DA (July 14, 2017) ("One thing that's key from a debtor's perspective is appropriate transparency.").

135. *See* Telephone Interview with DA (June 6, 2017) ("[T]ypically, what I do [i]f I've got a small [debtor] . . . I tell them[,] . . .'Look, if you've got a local supplier or contractor, somebody you need, get them some money before you file, tell them what you're doing and why.' And, that works. It kind of takes some of the sting out of getting a bankruptcy notice cold."); Telephone Interview with DA (July 17, 2017) ("[E]xplain the circumstances and tell them that you want to keep doing business."); Telephone Interview with DA (Aug. 31, 2017) ("Where it's an important vendor and the relationship's important[,] my advice is usually to let them know either shortly in advance of the filing or upon the filing.").

> I mean it sort of becomes personal. . . . I don't know if it would have changed if they called me prior to or would have notified me that they were having some financial difficulties, and so forth. Then maybe I would have had a better feeling about the whole situation. But, it was a surprise. . . . I would not want to do any business with them in the future.[136]

The unpleasantness of surprise was echoed by others, many of whom felt as though an honest debtor would have or should have reached out in advance of the filing.[137] In at least one interview, the reason given for wanting advance notice was not only so the creditor could prepare itself, but also so the creditor could have explored "some way we could have worked with them to avoid filing."[138] Attorneys reported seeing similar responses in practice, indicating that creditors were more willing to be cooperative after the fact in situations where creditors felt the debtor had been upfront and transparent with solvency issues,[139] or even apologetic about the financial failure.[140] One debtor interviewed indicated that the company had decided to inform its creditors of the trouble six months prior to bankruptcy, and it reported a particularly high level of cooperation from creditors post-bankruptcy as a consequence.[141]

Creditors seemed to be particularly sympathetic to debtor explanations that identified outside factors as the ultimate cause for filing, which is consistent with the findings of previous studies on relationships' response to stress.[142] Multiple creditors reported maintaining relationships with debtors and being motivated to cooperate in bankruptcy proceedings because the

---

136. Telephone Interview with C-B (July 14, 2017).

137. *See* Telephone Interview with C (June 7, 2017) ("[I]f he had tried to work with us before then . . . you know, we could probably still do business."); Telephone Interview with C-B (July 14, 2017) ("I wish they would have been more [communicative] and reached out to me."); Telephone Interview with PC (Sept. 8, 2017) ("They could have notified me ahead of time. That would have helped, because it came out of the blue.");

138. Telephone Interview with C (Oct. 11, 2017).

139. *See* Telephone Interview with CA (June 21, 2017) ("[I]n general in those situations [where debtors have given a false view of the financial wherewithal of the company], creditors feel jilted and usually there's a trust relationship that's been built up many times with trade creditors over the years so in those cases there's a very sour feeling.").

140. *See* Telephone Interview with DA (Aug. 31, 2017) ("[A]nother point we always try to make is, we really feel badly about the accrued payable. There's nothing we can do about that now . . . .").

141. *See* Telephone Interview with D (June 2, 2017).

142. *See* Jonathan D. Hibbard, Nirmalya Kumar & Louis W. Stern, *Examining the Impact of Destructive Acts in Marketing Channel Relationships*, J. MKTG. RES., Feb. 2001, at 45, 54.

Published by University of Oklahoma College of Law Digital Commons, 2019

debtor had made clear that the bankruptcy filing was a consequence of a third party's actions, such as the bank pulling a loan or an essential account of the debtor going unpaid.[143] In other scenarios, the debtor's industry could make a difference, like where creditors within the industry were generally aware of financial pressures that could lead a party to file and were thus more sympathetic.[144] As eloquently expressed by one creditor, "[W]hen you don't have no money, you don't have no money."[145]

However, if creditors were sympathetic in cases where the debtor seemed to be a victim of its circumstances, they tended to be highly unsympathetic when the bankruptcy appeared to be deliberate and strategic. As one creditor reported, the owner of the creditor and the principal of the debtor had maintained a personal relationship prior to the bankruptcy.[146] The debtor made reassurances to the creditor in the days leading up to bankruptcy, but it then cut off all communication upon filing.[147] As a consequence, the creditor "was very angry. . . . [H]e felt like [the debtor] had lied to him and kind of just strung him along . . . . [H]e felt definitely betrayed."[148] Moreover, the creditor asserted that moving forward, "the owner here wouldn't service anything of [the debtor's] even if he came begging us."[149] Other creditors echoed the sentiment that, once a debtor had lost their trust, the debtor had also lost any hope of doing business going forward.[150]

Beyond honest communication prior to and during the bankruptcy, interviewees also suggested that the amount of payout within the bankruptcy could have an effect on creditors' decisions to cooperate with debtors, and

143. *See* Telephone Interview with C-JC (June 6, 2017) (describing explanation for debtor's financial woes indicated debtor had good intentions but no cash, prompting creditor to extend them credit quickly); Telephone Interview with C-BC (July 14, 2017) (referencing instance where bank pulled the debtor's line).

144. *See* Telephone Interview with C-JO (June 6, 2017) (e.g., oil and gas).

145. Telephone Interview with C-E (May 22, 2017).

146. Telephone Interview with C-R (May 22, 2017).

147. *Id.*

148. *Id.*

149. *Id.*

150. *See* Telephone Interview with PC (June 1, 2017); Telephone Interview with C-JC (June 6, 2017) ("If they can't stay true to their word and their promise that they said that they were going to pay us, then there is a character flaw there. So, we don't care to do business with that."); *see also* Telephone Interview with CA (May 30, 2017) ("[S]ometimes if you feel like the guy hasn't been honest or truthful with you, it may not matter how much. There's no way you're doing business with them again."). In some cases, the reason for the loss of trust was unknowable. One debtor's principal reported that he had lost a "very, very close relationship" with a creditor because "it just became totally personal," even despite the debtor's efforts to communicate "almost daily." Telephone Interview with D (June 2, 2017).

https://digitalcommons.law.ou.edu/olr/vol71/iss4/3

many connected the willingness to pay with perceptions of honesty and being true to one's word. As one creditor observed, if a debtor voluntarily repaid its discharged debt following a bankruptcy proceeding, this would be an expression of honesty and trustworthiness, and "I would instantly give them credit. No problem at all."[151] Beyond what the plan payment had to say about trust and commitment, however, interviewees did not agree on whether the amount repaid had an independent influence on cooperation.[152]

3. Influence of Pre-existing Relationship Commitment

In addition to referencing specific acts demonstrating trustworthiness or betrayal, interviewees frequently pointed to perceptions regarding the pre-existing relationship or ongoing relationship commitment as a deciding factor in how to respond to a debtor's bankruptcy. These references were again consistent with prior research, which has observed that "efforts at nurturing trust and commitment with dealers builds a reservoir of goodwill on which the supplier can draw in the face of perceived destructive events."[153] Creditors indicated that the previous length and quality of the relationship would be a factor in a decision to continue the relationship following a bankruptcy.[154] As expressed by one creditor,

> [The decision to continue a relationship after bankruptcy is] not necessarily credit collection's decision . . . sometimes it's the decision of our sales people that are involved. How they view the relationship as a group, we talk about the ability of the company to actually come out of the bankruptcy. Whether or not it's a

151. Telephone Interview with C-JC (June 6, 2017).

152. *See* Telephone Interview with DA (May 25, 2017) ("[I]f the payout is small, they may be hesitant to deal with the debtor going forward, because they don't want to get burned again."); Telephone Interview with DA (June 20, 2017) (indicating that in cases where unsecured creditors attempt to undermine the reorganization, the motivation may be in the payout but, even more so, may be "what led up to the filing, how they contested litigation or things like that"); Telephone Interview with CA (June 21, 2017) (observing that in one case creditors receiving a 15% payout over several years were notably cooperative "because they want the company to succeed"). In one of the surveyed cases, the debtor did manage to pay all unsecured credit in full, and creditors reported being very satisfied with the outcome, as well as continuing their relationship with the debtor. Telephone Interview with PC (May 18, 2017); *see also* Telephone Interview with PC (May 30, 2017).

153. Hibbard, Kumar & Stern, *supra* note 143, at 57.

154. *See* Telephone Interview with PC (June 1, 2017).

Published by University of Oklahoma College of Law Digital Commons, 2019

> relationship we'd like to continue, if we see some benefit in it . . . .[155]

Thus, the quality of the relationships in the past directly influenced the perceived ongoing value of the relationship.[156] At least one debtor noted that creditors were more likely to be cooperative if there was a "human" rather than a "corporate" relationship between the two companies and that a lack of such a relationship "has dramatically harmed us."[157]

In some cases, the strength of the relationship commitment, at least on the creditors' side, might have arisen less from positive past experiences and more from the size or importance of the debtor. Often, creditors would explain their ongoing relationship with a debtor by pointing to the lack of alternative business in the area.[158] As one creditor put it, "there's not a lot of forty[-]store chains out here bouncing around that we can go get their business."[159] Others reflected similar sentiments.[160]

A second narrative that arose—somewhat unexpectedly—from the interviews demonstrated that, just as relationships could be damaged beyond repair by a debtor's perceived betrayal, so relationships could be ended based on the debtor's loss of trust in a creditor. Several interviewees referenced situations where the debtor, while generally attempting to preserve relationships, might elect not to continue doing business with particular creditors because of their actions during the bankruptcy proceedings. In one case, the debtor observed that two of its most essential trade creditors had joined a creditor's committee and then insisted on being critical vendors,

---

155. Telephone Interview with PC (June 1, 2017).

156. *See* Telephone Interview with C-JO (June 6, 2017) ("This sounds terrible, but part of it probably depends on the type of customer they had been up to the bankruptcy."); *see also* Telephone Interview with CA (June 6, 2017) (noting that trade creditor reaction to bankruptcy will largely depend on the history between the trade creditor and debtor).

157. Telephone Interview with D (June 22, 2017); *see also* Telephone Interview with DA (May 25, 2017) (observing that close business relationships can be very helpful to a debtor in bankruptcy).

158. *See* Telephone Interview with PC (May 30, 2017).

159. *Id.* (observing that even though debtor was always a late payer, they "had to suck it up and appreciate their business and continue servicing their stores").

160. Telephone Interview with C (May 18, 2017) ("[I]f they're a massive chain . . . we still service [them]."); *see also* Telephone Interview with C-E (May 22, 2017); Telephone Interview with D (June 2, 2017) ("[T]hey stayed with us for two reasons: [1] relationships, I mean if we didn't have the relationship with the vendor, they wouldn't have stayed[,] . . . [2] they need us on a go-forward basis as much as we need them, if not more."); Telephone Interview with CA (July 26, 2017) (noting that relationship commitment post-bankruptcy depends on how important the debtor is as a customer).

charging a premium on goods and services going forward and demanding payment on a cash-only basis. The debtor responded, somewhat indignantly, by finding new vendors.[161] In other cases, a creditor's decision regarding whether to join a creditor committee was itself viewed as a possible betrayal, insofar as it meant taking an adversarial stance against the debtor.[162]

IV. Preferences

When interviewees described a general willingness of trade creditors to cooperate with debtors post-filing, they frequently introduced an unprompted caveat concerning debtors that filed preference actions against creditors. As one debtor's counsel put it, "that'd be a point where [trade creditors] would draw a line."[163] Although relatively common within bankruptcy proceedings generally,[164] preference actions are notorious for being poorly understood by the population at large, including businessmen and creditors. This is true even among those who are generally informed regarding bankruptcy laws. Accordingly, individuals and companies who find themselves on the wrong end of preference liability are, more often than not, shocked and outraged at the prospect of owing money back to the debtor's estate on account of otherwise legal collection activity.[165] As reported by the attorneys I interviewed, it was not uncommon for business people to express a sense of disbelief that avoidance actions pursuant to preference liability are the law of the land, describing preference law as unfair, outrageous, and even "un-American."[166]

---

161. Telephone Interview with D (June 22, 2017) ("That's not [being] a critical vendor, that's being a thief . . . .").

162. *See* Telephone Interview with PC (May 30, 2017) (noting that the debtor was not happy with the creditor's affiliation with the committee because "they thought that I was suing them too"); Telephone Interview with D (June 2, 2017) (noting that cooperative trade creditors were actively recruited to sit on the creditor's committee, but made a point of asking the debtor's advice first, and then typically electing not to sit on the committee); Telephone Interview with CA (June 21, 2017) (noting that creditors avoid sitting on the creditor's committee because they do not want to be viewed as the enemy of the debtor).

163. Telephone Interview with DA (Aug. 31, 2017).

164. *See* TABB, *supra* note 78, at 488.

165. *See* Telephone Interview with DA (July 17, 2017).

166. *See* Telephone Interview with DA (June 6, 2017) ("One of the hardest things for a practicing attorney to explain is to the creditor who gets a preference demand letter. And it's usually, '[W]hat kind of country is this? This is unconstitutional. This is un-American.'").

Published by University of Oklahoma College of Law Digital Commons, 2019

A. Reactions to Preference Liability

The perception of preference actions as a betrayal and destroyer of relationships was practically universal across interviewees. Preference actions were described as the height of betrayal, "a slap in the face,"[167] particularly insofar as they target creditors who "view themselves as trying to help during this time of distress" by continuing to extend credit.[168] In one case, a preference action was brought against a creditor with a long-standing prior relationship with the debtor's principal. In that scenario, the creditor indicated that the debtor "knew, well in advance that this was about to happen. And, [he] continued to do business as usual . . . ."[169] In expressing his outrage and disbelief at the perceived betrayal, the creditor indicated, "I mean in all honesty, he better never turn the corner and see me."[170] As another creditor put it, "This is stealing. I don't care what the regulations are saying, you can declare bankruptcy whenever and you can take money back from us? It's still stealing from us."[171]

Not surprisingly, based on these reactions, interviewees frequently reported the expectation that a preference action would spell the end of the relationship between debtor and creditor, no matter the length of the relationship.[172] As one debtor's attorney opined, "I think if you file a preference action against [creditors], they get completely irrational. Now you're trying to take something away that they already got, and that will make most of them livid and they will cease doing business with you."[173] As another explained, "a creditor can live with the idea that they're not going to get paid on their debt. What they can't live with, what is totally unacceptable and foreign, is the idea of giving the money back, and they haven't been

167. Telephone Interview with CA (May 18, 2017).

168. *Id.*

169. Telephone Interview with PC (May 22, 2017).

170. *Id.*

171. Telephone Interview with PC (June 19, 2017).

172. *See* Telephone Interview with DA (May 19, 2017) ("[T]he person who you're collecting it from, they're never going to do business with you again or sell you whatever they're selling you."); Telephone Interview with DA (June 6, 2017) ("If there was a relationship there isn't going to be afterwards."); Telephone Interview with DA (June 20, 2017) ("That's usually . . . the thing that can put the creditor over the edge."); Telephone Interview with DA (Aug. 31, 2017) ("Well, no question, it affects [the relationship] negatively."); Telephone Interview with DA (Sept. 8, 2017) ("They're not going to want to do business with you. . . . It's a disincentive to put it mildly."); *see also* Telephone Interview with CA (May 18, 2017); Telephone Interview with CA (May 25, 2017); Telephone Interview with CA (May 30, 2017).

173. Telephone Interview with DA (May 25, 2017).

https://digitalcommons.law.ou.edu/olr/vol71/iss4/3

paid."[174] Attorneys were so confident in their conclusions that a preference action would end a business relationship that they often reported advising their clients to avoid preference actions against any individual with whom they would like an ongoing relationship.[175] Many creditors who had been subject to preference actions affirmed this perception, reporting that they ceased to do business with the company that sued them based on a lingering "sour taste" in the mouth, whether or not the preference suit was successfully defended.[176]

However, this perspective was not universally shared, nor universally demonstrated among interviewees. One highly experienced creditors' attorney opined that most creditors are too focused on sales going forward to get hung up on the insult of past preference actions.[177] This opinion found support in reports of creditors who continued their relationship with a reorganized debtor, or more often, the purchaser of the debtor, even after a preference action had been prosecuted against them. The reasons creditors gave for continuing the relationship despite their keen sense of betrayal and frustration included the need to sell product and the desire to continue good relationships with principals of the debtor, who creditors often did not view as responsible for the preference action itself. As one creditor reported, it continued to do business with the reorganized debtor "because sometimes we'll have a [product] that nobody else wants. . . . If we can sell it to somebody else, we definitely do." [178] Another explained that they continued to do business with the reorganized debtor "only because I did trust the CEO," and wanted to see a twenty-year project to completion.[179] They added, "If I had not known the CEO ahead of time and if I had not dealt with him personally, and known of his character, [the preference action] would have

---

174. Telephone Interview with DA (July 17, 2017).

175. *See* discussion infra note 214.

176. *See* Telephone Interview with PC (July 11, 2017) ("I do kind of have a little sour taste in my mouth about that. . . . I don't know that I would be willing to do business with that company again."); Telephone Interview with PC (Aug. 31, 2017) (reporting that, after doing business with the debtor for 10-15 years prior, they gave up the relationship based on the amount lost in the preference claim); Telephone Interview with PC-L (Sept. 7, 2017) ("We have nothing to do with them whatsoever. . . . It left a nasty taste in everybody's mouth."); Telephone Interview with PC (Sept. 14, 2017) ("I wouldn't touch that thing with a ten-foot-pole, man. Are you kidding?").

177. Telephone Interview with CA (June 6, 2017).

178. Telephone Interview with PC (June 19, 2017).

179. Telephone Interview with C (Sept. 8, 2017).

Published by University of Oklahoma College of Law Digital Commons, 2019

left a very bitter taste in my mouth too."[180] As noted by one attorney, the ability of creditors to compartmentalize their frustration with preference actions and distinguish between the perceived betrayal of the debtor and the ongoing trustworthiness of the reorganized debtor may be influenced by the fact that most preference actions are brought by third parties, such as a liquidating trust or the creditor's committee.[181]

B. The Impact of Preference Actions on Trade Creditors and Its Influence on Trade Credit

Discussions with interviewees indicated that preference actions impose a significant burden on creditors, particularly when creditors are less sophisticated and therefore less able to anticipate the loss and expense associated with a preference action. As one creditor operating a family business reported, the delay between the payment and the claw-back was highly problematic. "It's not like you've just received money, and when you do receive money, you've already put out a whole lot in order to make the money and you have a lot of bills to pay . . . ."[182] Particularly for smaller businesses, maintaining a consistent cash flow is a constant concern,[183] making unwelcome and unanticipated costs particularly burdensome. In summary, "it was really hard emotionally and it was hard financially on us to have to give that money back."[184] A further burden was often imposed by the perceived need to hire an attorney, which inevitably added to creditors' expenses, although it often resulted in a more favorable outcome in the preference action.[185]

Creditors, particularly those who encountered preference actions for the first time, tended to respond to the perceived increased risk for future preference actions by restricting their future credit. As one creditor explained,

---

180. *Id.*; *see also* Telephone Interview with C (Sept. 8, 2017) (reporting ongoing relationship with the same company based on relationship with the same CEO).

181. *See* discussion *infra* note 214; Telephone Interview with CA (July 26, 2017).

182. Telephone Interview with PC (June 19, 2017).

183. *See* Email from Paul Schrader, Fullerton Law, to Brook E. Gotberg (Mar. 29, 2018, 08:31 CST) (on file with author) (noting the importance of short run cash flow to creditors).

184. Telephone Interview with PC (June 19, 2017).

185. *See* Telephone Interview with PC (Sept. 8, 2017) (settling for 5% of demand, but paid three times that amount in attorneys' fees); Telephone Interview with PC-L (Sept. 7, 2017) (defending preference action after hiring an attorney); Telephone Interview with PC (Sept. 14, 2017) (noting the expense of the preference action included thousands in attorneys' fees).

> Nobody's ever owed me that much money again. . . . I've got customers that I've done business with for years, same kind of situation, and basically, I'd let them get maybe [thirty to ninety] days out on me. Don't do it no more. You just lock them into [thirty] days, and if they don't you cut them off. It's just not worth the risk. . . . [I]t makes you tighten up all of your financial aid to people, which makes it hard for these other businesses because you won't extend them as much credit. But you just can't afford to take these risks anymore. You can't extend credit to guys anymore. . . . [M]ost everybody is on a cash basis: you want it, you pay me and you get it.[186]

Others echoed this approach, reporting that they had tightened their credit terms for all customers after the preference action.[187]

C. Strategic Preference Actions

Attorneys, both on the debtor and the creditor side, largely recognized preference actions as strategic tools and referenced decisions to bring preference actions selectively. Both debtors and debtors' counsel reported acknowledging the harm that preference actions can cause to debtor/creditor relationships, and they accordingly expressed reluctance to bring preference actions unless absolutely necessary or strategically desirable. Most attorneys agreed that preference actions could be brought or abandoned pursuant to the debtor's strategic needs.

Accordingly, attorneys who represented debtors frequently reported that they would not pursue preference actions that were likely to permanently terminate important business relationships.[188] Citing the "unwritten rules of a preference action," one attorney put it bluntly: "[W]here a debtor

186. Telephone Interview with PC (May 22, 2017).

187. *See* Telephone Interview with PC-B (Sept. 7, 2017) ("[W]e're more risk-averse [now] than we were, so that means companies that need help don't get as much of our expertise."); Telephone Interview with C (Sept. 14, 2017). This reaction is consistent with that observed in other studies. *See* Hibbard, Kumar & Stern, *supra* note 143, at 54 (observing that perceived acts of betrayal lead to disengagement). For an interesting analysis of a study on practice reciprocity, or how players in a strategy game respond to acts of defection or cooperation, see ROBERT AXELROD, THE EVOLUTION OF COOPERATION 118-20 (1984).

188. *See* Telephone Interview with CA (May 30, 2017) ("[W]hat is the impact of me suing this trade creditor going to have on my business?"); Telephone Interview with CA (June 21, 2017) ("If you are on the debtor's side you never want to file [preference actions] unless you hate the creditor that you're filing against. I mean, because it's not good business."); Telephone Interview with DA (Aug. 31, 2017) ("I can't recall, sitting here, an instance where we filed a preference claim against a post-petition vendor.").

Published by University of Oklahoma College of Law Digital Commons, 2019

reorganizes and continues to do business with the vendor, that vendor is not going to get sued for a preference."[189] Counsel also pointed to the probable negative consequences for the debtor's reputation as a reason not to pursue preference actions.[190] The overall result was that preference actions tended not to be brought in a reorganization where the business would continue as a going concern.[191]

Not all attorneys agreed with the view that preference actions are permissive rather than mandatory. Two of the seventeen interviewed expressed the opinion that the debtor would be required to make a demand for an available preference, even if the debtor did not wish to do so out of concern for the potential impact on the debtor's relationship. They cited the fact that, in bankruptcy, the DIP becomes a fiduciary to its creditors, who in turn become the residual owners of the business in the way that shareholders are in solvent companies.[192] In addition, they pointed to concerns that, should the DIP not pursue obvious preferences, the creditors could make a stronger case for appointing a trustee over the estate who would pursue the preferences.[193] Other creditors appeared to acknowledge this second concern, but they suggested that such pressure rarely comes into play following plan

---

189. Telephone Interview with DA (Sept. 8, 2017).

190. *See* Telephone Interview with CA (May 25, 2017) ("[Y]eah I've got preferences, but I don't intend to assert them because I think the cost of doing business and the reputation[] loss . . . is not worth the effort."); Telephone Interview with DA (July 17, 2017) (noting that it is a balancing act to decide whether recovery of the preference amount is worth the cost to the relationship).

191. *See* Telephone Interview with DA (May 19, 2017) ("[I]f you're working with a client and he's selling you something that you need and you have a good relationship with him, you're not going to sue him . . . . Especially if your plan's been confirmed. I just don't see that happening much. But, you do see it a lot in the liquidation cases."); Telephone Interview with DA (May 25, 2017) ("[T]ypically, in a true reorganization as opposed to a sale case or a liquidation . . . [a] true reorganization you normally give up, waive, any right to bring preference actions as part-and-parcel of your confirmation process."); Telephone Interview with CA (May 30, 2017) ("[A]n ongoing Chapter 11 debtor that needs the relationship [is] not going to pursue the preference action against a party that is needed for the business . . . ."); Telephone Interview with DA (July 14, 2017) ("Is it a liquidation or a reorganization? Because, there is more likely to be a preference action[] actually pursued in a liquidation. Because, otherwise the creditor relationships are more important in a reorganization.").

192. *See* Telephone Interview with DA (June 6, 2017) ("I think you have to. I don't think you're doing your job if you don't. . . . [Y]our debtor's a fiduciary, they got to do what's right."); Telephone Interview with DA (June 23, 2017) ("You really can't do that, when you're representing a chapter 11 debtor. You're a fiduciary of the debtor in possession.").

193. *See* 11 U.S.C. § 1104 (2018) (allowing the court may order the appointment of a trustee on request of a party "if such appointment is in the interests of the creditors"); Telephone Interview with DA (June 6, 2017).

confirmation, which is when a preference action is most likely to be brought.[194] Attorneys also noted that the presence or absence of possible defenses would weigh into the calculation of whether to file a preference action,[195] although demands made through an informal letter campaign might be made at the drop of a hat.[196] It appears unsettled whether a debtor has a legal duty to bring available preference actions; nevertheless, the issue raises interesting questions about the extent to which a debtor's fiduciary duties in a reorganization involve engaging in potentially self-destructive actions.

For most attorneys, however, preference actions were desirable only in cases where the targeted creditor was no longer important to the debtor or the preference action was otherwise viewed as strategically necessary.[197] Several attorneys did acknowledge bringing a preference action as a strategic defense to encourage the reduction of a creditor's claim against the estate.[198] In these

---

194. *See, e.g.*, Telephone Interview with CA (June 21, 2017). Some reported cases have indicated that creditors may force a preference action, or obtain standing to bring a preference action, in scenarios where the debtor has failed to do so. *See, e.g.,* Canadian Pac. Forest Prods. Ltd. v. J.D. Irving, Ltd. (*In re* Gibson), 66 F. 3d 1436, 1438 (6th Cir. 1995) (permitting a single creditor to initiate an action to avoid a preferential transfers if the creditor has demonstrated a likelihood of success, and a demand on the debtor to bring the action has been unjustifiably refused). The court in *In re Gibson* specifically cited to concerns that the debtor would use preference actions "as a sword to favor certain creditors over others," noting that "we do not believe Congress intended to exclude creditors from seeking to avoid preferential or fraudulent transfers where the debtor-in-possession [so] abuses its discretion." *Id*. at 1441.

195. *See* 11 U.S.C. § 547(c). For an explanation of these exceptions, see Gotberg, *supra* note 5, at 67-77.

196. This observation was even more accurate outside the chapter 11 context, particularly for chapter 7 trustees. *See supra* note 21; Telephone Interview with CA (May 25, 2017); Telephone Interview with DA (May 25, 2017); Telephone Interview with DA (June 23, 2017) ("[Y]ou're going to send at least a demand to see if he can shake the trees and get money out of them."); Telephone Interview with DA (July 14, 2017) ("Mostly people look at preferences like, let me try and shake the tree to see if I can get some extra money.").

197. *See* Telephone Interview with DA (May 19, 2017) ("I mean it's only a good idea if you really need the money. But, if you're going to get your plan confirmed and it's financed then it's been confirmed, there isn't a great need for the preference recovery, unless you just have to collect some money. And so, it almost doesn't pay to do it."); Telephone Interview with CA (May 25, 2017) (noting the filing of preference claims when "the principal didn't really care about the creditor anymore, didn't need the creditor's support"); Telephone Interview with CA (June 21, 2017) ("[I]f you want to have a good supply relationship with your vendors, or if you want the gardener to mow your lawn, you're not going to be suing them. Or, if you do it, you file a lawsuit as a cover for you doing your fiduciary duty, but 'wink' let's do a deal whereby, you know, that's favorable.").

198. *See* Telephone Interview with DA (May 19, 2017) (detailing preference action that was brought to reduce size of claim); Telephone Interview with D (June 2, 2017) (reporting that preference action was brought against a particular creditor because "[t]hey became

Published by University of Oklahoma College of Law Digital Commons, 2019

cases, the loss of the business relationship was acknowledged as a foregone conclusion because it was usually viewed as beyond saving.[199] Other strategic uses for preference actions included bringing the suit in order to exclude the creditor's claim so that the targeted creditor would be ineligible to vote on the plan of reorganization.[200]

Another interesting point regarding the use of preference actions in reorganization cases was the frequently-raised issue of timing. A preference action may be brought up to two years after the bankruptcy filing,[201]and potentially longer if a trustee is appointed or the case is subsequently converted to a chapter 7 proceeding. Accordingly, a creditor can be subject to a demand for repayment of a preference after it has already agreed to a plan of reorganization and accepted a reduced payout plan for its remaining debt.[202] Depending on the case, the plan of reorganization may have already been confirmed.[203]

---

exceptionally, outrageously aggressive, trying to create things that didn't exist"); Telephone Interview with D (June 22, 2017) (explaining that preference action was used "to try to ascertain and force somebody to make a decision or negotiate for the sake of the company so that we're not stuck in a legal battle forever, trying to figure out who has first right to anything and to be able to function").

199. *See* Telephone Interview with D (June 22,2017).

200. *See* Telephone Interview with DA (May 19, 2017). It was unclear on what basis bringing the preference action would disqualify a given creditor. A pending cause of action against a creditor could make the creditor ineligible to serve by virtue of a conflict of interest. *See In re* First Republic Bank Corp.,95 B.R. 58, 61 (Bankr. N.D. Tex. 1998). Alternatively, if the creditor's claim is disallowed pursuant to 11 U.S.C. § 502(d) for failure to turnover property subject to a preference action, the creditor may not be permitted to serve on the committee.

201. *See* 11 U.S.C. § 546(a) (2018).

202. *See id.* As one interviewee pointed out, preference actions may even be made against individuals who were not creditors at the time the chapter 11 plan was voted on and confirmed, but who subsequently become creditors, bound by the plan, when the debtor brings a preference action against them. Such a result has the effect of disenfranchising creditors and it raises questions regarding whether preference actions should only be allowed prior to plan confirmation. *See* Telephone Interview with CA (Aug. 8, 2017) ("I think there's a fair argument to be made that preference and other avoidance actions must be brought[,] if at all, pre-confirmation.").

203. There is no stated timeframe in which a plan must be confirmed, although a court may allow other parties to propose a plan if the debtor has not successfully confirmed a plan within a given time frame. *See* 11 U.S.C. § 1121. For most cases, preference actions will still be available after plan confirmation. *See* Foteini Teloni, *Chapter 11 Duration, Pre-Planned Cases, and Refiling Rates: An Empirical Analysis in the Post-BAPCPA Era*, 23 AM. BANKR. INST. L. REV. 571, 582-83 (2015) (finding a duration mean of 430 days between filing and confirmation of plans for companies in traditional chapter 11 cases after 2005).

https://digitalcommons.law.ou.edu/olr/vol71/iss4/3

Attorneys seemed particularly attuned to this discrepancy, and they noted the strategic advantage of waiting to file a preference action until after the plan had been confirmed, in large part, because the debtor would no longer require the targeted creditor's vote in favor of confirmation.[204] For at least one creditor, the strategy was somewhat effective.[205] In addition, attorneys noted that preference actions may be a bargaining chip with a creditor's committee, which may be for or against the pursuit of such actions in any given case, and preferences may be explicitly dealt with in the plan.[206] One attorney also suggested that the delay can help the debtor because the creditor will have already made the choice to continue doing business with the company.[207] When the company commences timely payment in bankruptcy, this encourages further continuation of business despite a subsequent preference action.[208]

More commonly, interviewees reported that companies in reorganization would decline to bring preference actions at all, instead assigning such actions to a separate trust or to the creditor's committee itself.[209] In doing so,

---

204. *See* Telephone Interview with DA (May 19, 2017) ("[A] lot of times, people wait until after the plan is confirmed and then sometimes they'll pursue those actions and sometimes not."); Telephone Interview with DA (June 23, 2017) ("[I]f it's in a chapter 11 you typically try to avoid doing those [preference actions] until after the plan's confirmed or something. Because if you do that during the pendency of the case you're going to not have a very happy creditor. They're not going to be too terribly supportive of your reorganization efforts."). This activity has been taken to some extremes, as in the case of *In re* DPH Holdings Corp., in which the debtor requested, and was granted, leave to file preference complaints under seal prior to obtaining confirmation. Filing of the complaints was necessary to toll the statute of limitations, but the debtor argued successfully before the court that the actions should be kept secret so as to not affect the vote. *See* Jeffrey A. Wurst & Michael T. Rozea, *Secret Extensions – Preference Actions Avoiding the Statute of Limitations*, ABF J. (March 2011) at https://www.abfjournal.com/articles/secret-extensions-preference-actions-avoiding-the-statute-of-limitations/.

205. *See* Telephone Interview with PC (May 30, 2017) ("[W]e didn't know about the preference until two years after they declared bankruptcy.").

206. *See* Telephone Interview with DA (June 20, 2017) ("[W]e've seen a trend a little bit in some retail cases where a negotiated resolution with the creditor's committee may be that the debtor agrees not to file preference cases. So, it's a negotiating tool, and usually you wait until the end unless there's a significant preference issue that you need to file early in the case."); Telephone Interview with DA (Sept. 8, 2017) (explaining situation in which creditor's committee obtained the right to preferential transfers from a liquidating trust, but only "against vendors that were no longer deemed critical").

207. Telephone Interview with CA (Aug. 8, 2017).

208. *See id.*

209. This approach has been upheld as lawful. *See, e.g.*, Commodore Int'l Ltd. v. Gould (*In re* Commodore Int'l Ltd.), 262 F.3d 96, 100 (2d Cir. 2001) (holding that a creditors'

Published by University of Oklahoma College of Law Digital Commons, 2019

the debtor could assert plausible deniability in the face of creditor outrage.[210] One attorney explained that, particularly in recent years, the model has shifted from a true organization to a sale of the business and the establishment of a liquidating trust.[211] As a consequence, the debtor need not concern itself with the ongoing business relationships; instead, these relationships become the concern of the purchaser of the debtor's assets.[212] Attorneys overwhelmingly reported that buyers of assets as a going concern were concerned with the impact preference actions had on business relationships. Often, attorneys advised buyers to purchase any preference claims as part of the agreement and then abandon those claims to avoid disruption to necessary business relationships.[213] As one attorney put it, "if I represent a buyer [then] I'll buy the preference claims too if I can[,] [b]ecause I can just cancel. If I buy the business, then I will buy the preference claims so that I don't have some bankruptcy estate suing my suppliers."[214]

In summary, debtors and their representatives generally acknowledged that preference actions harm debtor efforts to reorganize and are accordingly avoided if at all possible. When they are pursued, it is because the targeted creditor is no longer deemed essential to the debtor's reorganization efforts,

---

committee may acquire standing to pursue the debtor's claims with consent of the DIP or the trustee, when the suit is in the best interests of the bankruptcy estate and "necessary and beneficial" to the fair and efficient resolution of the case).

210. *See id.* ("[W]e tried very hard to peel off the preference actions into a trust for the benefit of creditors. So, that when the company reorganized and the trustee went and did those preference actions and the creditors screamed, we as counsel to the reorganized debtor could say, 'That's not us.'").

211. *See* Telephone Interview with DA (June 19, 2017) ("[T]his isn't the older days where we actually had . . . to worry about those kinds of continued relationship issues. It's just different. [Debtors don't worry about a continuing relationship] because they're not going to be the debtor, typically. I mean, almost every case ends up in a [§]363 sale."); *see also* Douglas G. Baird, *The New Face of Chapter 11*, 12 AM. BANKR. INST. L. REV. 69, 73 (2004); Elizabeth Warren & Jay L. Westbrook, *Remembering Chapter 7*, 23 AM. BANKR. INST. J. 22 (2004).

212. Telephone Interview with DA (June 19, 2017) ("[S]o then it's really the new buyer that has to worry about how the outstanding preferences are going to impact its purchase.").

213. *See, e.g.*, Telephone Interview with CA (June 21, 2017) ("Sometimes the buyer will buy those litigation claims and not ever pursue them because the buyer doesn't want a liquidating trustee to sue them because they're suppliers now."); Telephone Interview with CA (July 26, 2017) ("[W]e have seen in the sale of asset cases where buyers through their asset purchase agreements . . . then assum[e] the preference actions, essentially buying those actions from the bankruptcy estate, and out of the self-interest that they don't want to[] sue future customers as part of their acquisition . . . ."); Telephone Interview with DA (Sept. 8, 2017) ("The buyer, I think the vast majority of the time, negotiates to protect vendors that they will continue to do business with.").

214. Telephone Interview with DA (July 14, 2017).

or because the strategic advantage of the preference outweighs its perceived harm. Furthermore, when actions are brought, DIPs take pains to transfer them to third parties to prosecute in order to absolve themselves of responsibility in the eyes of creditors. These findings speak to how preference avoidance actions are actually viewed and used in chapter 11 and why.

V. Relational Preferences

The reported use of preference actions as a strategic measure to distinguish between favored and less-favored creditors is shocking when preferences are understood as an effort to promote the equal treatment of creditors. However, this use is predictable when preference actions are seen as yet another tool provided to a chapter 11 debtor to promote its own reorganization. If bankruptcy in chapter 11 is about business preservation, the use or non-use of preference actions on the basis of relationship status is both reasonable and expected.

In light of what we know about business relationships and their response to perceived acts of betrayal, it should not be surprising that companies in bankruptcy hesitate to bring preference actions against valuable trade partners, and that they can justify that hesitation as being in the best interests of the company. As Steward Macaulay observed in his seminal work on the topic, there is a strong culture in business to avoid legal recourse when at all possible.[215] Macaulay reported one businessman as saying, "You can settle any dispute if you keep the lawyers and accountants out of it. They just do not understand the give-and-take needed in business."[216] The businessmen in Macaulay's study were so reluctant to exercise their rights against business partners that they would forgo legal remedies to which they were entitled.[217] This was explained in part by the perception that reliance on such recovery was unnecessary in light of prevailing non-legal norms and sanctions and that use of legal remedies could backfire. As Macaulay noted, "[b]oth business units involved in the exchange desire to continue successfully in business and will avoid conduct which might interfere with attaining this goal. One is concerned with both the reaction of the other party in the particular exchange and with his own general business reputation."[218] The power of reputation,

---

215. Stewart Macaulay, *Non-Contractual Relations in Business: A Preliminary Study*, AM. SOC. REV., Feb. 1963, at 55, 58.
216. *Id.* at 61.
217. *See id.*
218. *Id.* at 63.

Published by University of Oklahoma College of Law Digital Commons, 2019

Macaulay found, operates very effectively to encourage cooperative behavior, both in keeping commitments and in avoiding the impression that one is "inflexible" or too insistent on adhering to precise business terms.[219] Businesses may lose future customers by developing a reputation for unreliability or litigiousness.[220] In light of chapter 11's focus on business reorganization, concerns relative to the business's position and reputation vis-à-vis its partners is natural.

Furthermore, similar concerns about relationship preservation in bankruptcy arise in other chapter 11 contexts. For example, the pressure to retain business relationships with essential trade creditors, combined with the pressure to mollify these creditors with a credible promise of repayment, has justified the practice of granting so-called "critical vendor" motions in some circumstances.[221] The Bankruptcy Code does not define the term "critical vendor" nor does it provide any explicit guidance on what action may be taken to preserve a DIP's relationship with such a creditor. Instead, decisions about who to submit to the court as a critical vendor are left to the debtor, with the court typically granting or denying designation on a case-by-case basis.[222] The factors courts consider will vary, but they will typically involve some evaluation of how necessary a given creditor is and how unlikely it is that the creditor will continue to do business with the DIP absent such a designation.[223] For creditors who are designated as critical vendors, the DIP generally moves for the court to permit payment of certain pre-bankruptcy claims prior to the confirmation of a plan of reorganization.[224] Courts across the country have granted such motions, often pursuant to bankruptcy courts'

---

219. *Id.* at 64, 66 ("Holding a customer to the letter of a contract is bad for 'customer relations.'").

220. *See id.* at 61 (quoting one businessman as saying, "if something comes up, you get the other man on the telephone and deal with the problem. You don't read legalistic contract clauses at each other if you ever want to do business again. One doesn't run to lawyers if he wants to stay in business because one must behave decently").

221. *See* Alan N. Resnick, *The Future of the Doctrine of Necessity and Critical-Vendor Payments in Chapter 11 Cases*, 47 B.C. L. REV. 183, 183 (2005).

222. *Id.* at 184.

223. *See, e.g.*, *In re* CoServ, L.L.C., 273 B.R. 487, 498-99 (Bankr. N.D. Tex. 2002) (requiring debtor to demonstrate (1) vendor is "virtually indispensable to profitable operations or preservation of the estate"; (2) designation would realize "meaningful economic gain" or avoidance of "serious economic harm"; and (3) there is a lack of "practical alternatives"); *In re* Payless Cashways, Inc., 268 B.R. 543, 547 (Bankr. W.D. Mo. 2001) (considering "[w]hether approval of the borrowing is critical to the future of the business, given the condition of the business at the time the motion is heard, and given the status of its post-petition financing").

224. *See* Resnick, *supra* note 221, at 183.

https://digitalcommons.law.ou.edu/olr/vol71/iss4/3

ability under § 105 of the Code to "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title."[225]

Critical vendor motions are a topic of controversy within the bankruptcy field, both in their statutory justification and in their practical consequences.[226] As such, scholars have paid significant attention to the legitimacy of their use and the extent to which they impact bankruptcy proceedings.[227] However, until now scholars have not viewed preference litigation in a similar vein. As demonstrated above, preference actions can be seen as a counterpoint to critical vendor motions—the stick counterpart to the critical vendor carrot. Instead of providing an incentive to companies on the front end of a bankruptcy to continue their interactions with the debtor, it may be a punishment on the back end. Companies that are not essential, that resist the debtor's efforts to reorganize, or that might grant other strategic concessions may be subject to a preference action while others are spared. In this way, the motivation and use of preference actions in chapter 11 are analogous to critical vendor motions, and stem from concerns of debtor survival more than creditor equality or pre-bankruptcy behavior.

Conclusion

On the whole, the data gathered from this limited study of parties involved in bankruptcy proceedings suggests that preference law in chapter 11 is not used for the purpose of ensuring equality among creditors. Indeed, preference

---

225. 11 U.S.C. § 105(a) (2018).

226. *See, e.g.*, Joseph Gilday, *"Critical" Error: Why Essential Vendor Payments Violate the Bankruptcy Code*, 11 AM. BANKR. INST. L. REV. 411, 414 (2003) (referring to the practice of granting critical vendor motions as "unjust, unwise, and illegal"); Robert A. Morris, *The Case Against "Critical Vendor" Motions*, AM. BANKR. INST. J., Sept. 2003, https://www.abi.org/abi-journal/the-case-against-critical-vendor-motions ("For the same reasons that cause the debtor to have no short-term substitute for the critical supplier, that same supplier normally has no short-term substitute customer for that inventory and that production capacity.").

227. *See, e.g.*, Ashley M. McDow & Michael T. Delaney, *Critical Vendors – Necessity or Nullity*, 33 CAL. BANKR. J. 25, 25 (2014) (noting debate over the extent to which critical vendor claims should be permissible under the Bankruptcy Code); Resnick, *supra* note 221, at 212 ("[B]ankruptcy courts should, and likely will, continue the practice of authorizing the payment of prebankruptcy debt in certain situations."); Elizabeth Shumejda, *Critical Vendor Trade Agreements in Chapter 11 Bankruptcy*, 24 AM. BANKR. INST. L. REV. 159, 193 (2016) (noting in a study of chapter 11 cases that nearly three-quarters of the sample had approved critical vendor motions); Travis N. Turner, Kmart *and Beyond: A "Critical" Look and Critical Vendor Orders and the Doctrine of Necessity*, 63 WASH. & LEE L. REV. 431, 482 (2006) (noting the lack of explicit statutory authorization for critical vendor motions, but suggesting some sources for authority).

Published by University of Oklahoma College of Law Digital Commons, 2019

law is instrumental in ensuring that creditors are not treated equally. Instead, preference actions are used as a strategic tool of the debtor to punish recalcitrant creditors, to coerce greater cooperation on the threat of a lawsuit, or to obtain funding for administrative expenses from creditors who will not be needed as business partners moving forward. Accordingly, this Article recommends a shift in how preference actions are viewed and discussed in the chapter 11 context.

For one thing, it is illogical to view preference actions as serving creditors in chapter 11 proceedings. Rather, they serve the debtor's interest as a DIP. Although additional data gathering is necessary, the perception is that preference actions do not actually recover much, especially when one takes the expense of litigation into account.[228] One survey of practitioners estimated that the percentage of the claim settled for was, on average, 58.5% of the original amount identified as a preference.[229] Many interviewees in this study reported observing significantly smaller recoveries in their practice, but there was a wide range of reported amounts, and the facts of the case mattered.[230] Furthermore, the bar has expressed some skepticism that most

---

228. *See* McCoid, *supra* note 43, at 262 ("There is little information regarding the extent of recapture. The Administrative Office of United States Courts, which annually published bankruptcy statistics, publishes no figures on this."); *Bankruptcy Act Revision: Hearings on H.R. 31, 32, Before the Subcomm. on Civil and Constitutional Rights of the Comm. on the Judiciary (pt. 1)*, 94th Cong. 396-97 (1975) (statement of Peter F. Coogan); *id.* at 479-80 (testimony of Patrick A. Murphy); *id.* (pt. 3) at 1668-70 (1976) (statement of Richard Kaufman); James Angell McLaughlin, *Defining a Preference in Bankruptcy*, 60 HARV. L. REV. 233, 235 (1946). The perception among credit providers as reported in a 1997 survey was that preferences recoveries "never or rarely" increased distributions to unsecured creditors, although the response from bankruptcy practitioners to the same question reported that recoveries were frequently significantly increased by preference recoveries. AM. BANKR. INST. TASK FORCE ON PREFERENCES, PREFERENCE SURVEY REPORT 5 (1997) (Charles J. Tabb, Reporter).

229. AM. BANKR. INST. TASK FORCE ON PREFERENCES, *supra* note 228, at 8; *see also* Email from Paul Schrader, Fullerton Law, to Brook E. Gotberg (Mar. 26, 2018, 5:14 PM CST) (on file with the author) ("The take of trustees and counsel from preference recoveries is often in the 20% – 40% range.").

230. *See* Telephone Interview with CA (May 18, 2017) (referencing choking a $25,000 claim to $10,000); Telephone Interview with DA (June 6, 2017) ("They always settle and they always settle for 40 to 60 cents [on the dollar]."); Telephone Interview with CA (June 6, 2017) ("In the practical scheme of things they'll take fifty cents on the dollar back, sixty cents."); Telephone Interview with DA (July 14, 2017) (reporting settlements are 10-20% of what is owed); Telephone Interview with DA (July 17, 2017) (preference claims are settled for 20% or less of the face value); Telephone Interview with CA (July 26, 2017) ("As a rule of thumb [the settlement] should be less than 10%."); Telephone Interview with CA (Aug. 8, 2017) ("The only thing I guess I would say with certainty is less than half. I've seen as low as 10%

https://digitalcommons.law.ou.edu/olr/vol71/iss4/3

preference recoveries go to administrative expenses, rather than to repay creditors.[231]

As demonstrated above, preference proceedings in chapter 11 cases of reorganization are most likely motivated by a debtor's strategic concerns, and not by the desire to ensure equal distribution among creditors. Accordingly, observers should not be surprised by creditors' visceral negative reactions to the law of preferences. Insofar as preference actions serve a legitimate purpose in chapter 11 cases, it is to provide the debtor with the flexibility to manage its business relationships. As one attorney mused, "when all is said and done, the practice is at least as much about human relationships, trust and confidence, as it is about the technicalities of the Bankruptcy Code."[232] Preference actions in chapter 11 represent a debtor's ability to preserve or inflict harm on those relationships in order to obtain a desired end; that is, a successful plan of reorganization.

---

or less I suppose. It was rare that it was more than 50%."); Telephone Interview with DA (Aug. 31, 2017) (reporting settlement amount ranges from 25-90% of the claimed amount); Telephone Interview with DA (Sept. 8, 2017) (reporting settlement payments of up to 75% on transfers with no defense, and up to 25% on transfers for which there is a good defense).

231. *See, e.g.*, Thomas D. Goldberg, *Curbing Abusive Preference Actions: Rethinking Claims on Behalf of Administratively Insolvent Estates*, AM. BANKR. INST. J., May 2004, https://www.abi.org/abi-journal/curbing-abusive-preference-actions-rethinking-claims-on-behalf-of-administratively.

232. Telephone Interview with DA (July 17, 2017).

Published by University of Oklahoma College of Law Digital Commons, 2019

APPENDIX A

INTERVIEW GUIDE: CREDITORS

Last Revised 7/11/2017

BACKGROUND INFORMATION

1. Would you tell me a little bit about your business?

- What is the product or service that you produce?
- How many employees?
- Size in terms of revenues?
- Number of offices?
- Public or Private?
- How long have you been in business in your current market?
- What is your position?

2. Can we talk a bit about your relationship with [the debtor] prior to the debtor's bankruptcy?

- How long have you done business with [the debtor]?
- Who was your primary contact?
- How did your relationship with [the debtor] begin?
- What good or service did you provide to [the debtor]? OR what good or service did you receive from [the debtor]?

BANKRUPTCY PROCESS

1. Can you tell me what [the debtor's] bankruptcy was like for you, or how it affected you or your business?

- Were you surprised by [the debtor's] decision to file for bankruptcy?
- How did you find out that [the debtor] had filed for bankruptcy?
- How did you feel about [the debtor] filing for bankruptcy?
- What did you think that would mean for you and your company, if anything?
- Was this your first bankruptcy experience?

https://digitalcommons.law.ou.edu/olr/vol71/iss4/3

4. Were you ever contacted by [the debtor's] attorney? If so, can you tell me more about that experience?

5. Did you ever have cause to hire your own attorney to represent you in [the debtor's] bankruptcy proceedings? If so, why?

- How did you feel about the need to involve an attorney?
- Did you obtain an outcome you were satisfied with?
- If not, what outcome would you have liked to see?

If not, how did you negotiate the process?

- Did anything surprise you about the bankruptcy? How did you react to that?

POST-BANKRUPTCY EXPERIENCE

6. After the bankruptcy was over, did your relationship with [the debtor] change? If so, why, and in what ways?

- Did the bankruptcy affect the way you viewed [the debtor]?
- Did the bankruptcy affect [the debtor's] products or services?

7. Do you still maintain a relationship with [the debtor]?

- If so, why? If not, why not?
- Was this your preferred outcome?
- Would you have made the decision to maintain or not maintain the relationship if the bankruptcy had not happened?

8. Reflecting on the experience as a whole, is there any way in which the court, the attorney, or [the debtor] could have acted differently to obtain a better overall outcome?

Published by University of Oklahoma College of Law Digital Commons, 2019

APPENDIX B

INTERVIEW GUIDE: DEBTORS

Last Revised 2/9/17

BACKGROUND INFORMATION

1. Would you tell me a little bit about your business?

- What is the product or service that you produce?
- How many employees?
- Size in terms of revenues?
- Number of offices?
- Public or Private?
- How long have you been in business in your current market?

BANKRUPTCY PROCESS

2. What was it like to arrive at the decision to file bankruptcy? How did the decision come about? Did anything in particular influence your decision to file for bankruptcy?

- What did you think bankruptcy would mean for you and your company?

3. How did you make the decision to bring preference actions against your creditors?

- What was the outcome of the preference action?
- Was this the outcome you expected?
- Were there any unexpected consequences?

4. What was your overall experience with the bankruptcy process?

https://digitalcommons.law.ou.edu/olr/vol71/iss4/3

POST-BANKRUPTCY EXPERIENCE

5. After the bankruptcy was over, did your business relationships with your pre-existing creditors (list specific creditors associated with debtor) change? If so, why, and in what ways?

- Did the bankruptcy affect your ability to provide products or services?
- Do you feel like the bankruptcy changed others' perception of your business?
- Did you lose any relationships with creditors?

6. Were you happy with the outcome of your bankruptcy?

7. Reflecting on the experience as a whole, is there any way in which the court, the attorneys, or anyone else could have acted differently to obtain a better overall outcome?

- Was there anything about the process that surprised you?

Published by University of Oklahoma College of Law Digital Commons, 2019

APPENDIX C

INTERVIEW GUIDE: ATTORNEYS

Last Revised 7/19/2017

BACKGROUND INFORMATION

1. Would you tell me a little bit about your business?

- How long have you represented clients involved in bankruptcy?
- How often have you been involved in bankruptcy cases?
- Do you tend to represent more debtors or creditors, and what is the percentage?
- What size of cases do you generally deal with?

BANKRUPTCY PROCESS

2. Generally speaking, what is the reaction of creditors when they learn that a business or trade partner has filed for bankruptcy?

- From the debtor's perspective, what would be the ideal reaction?
- From the debtor's perspective, what would the ideal relationship with creditor's look like during the course of the bankruptcy?

3. How does a bankruptcy filing actually influence the relationship between debtors and creditors?

4. In your experience, how does the filing of a preference action affect the relationship between debtors and creditors?

5. What considerations do debtors tend to weigh in determining whether or not to bring a preference action in a chapter 11?

- Are there instances in which you had to counsel your client whether or not to bring a preference action?
- What factors came into play in making that decision?
- Were you surprised at all with the outcome of that decision? If so, how?

https://digitalcommons.law.ou.edu/olr/vol71/iss4/3

6. Do creditors ever see a preference action coming?

- Are they deterred from collection on the debtor?

7. How are preference actions typically resolved?

- Based on your experience, what percentage of preference actions brought by the debtor, a liquidating trust, or the chapter 7 trustee result in settlement? Is there a difference depending on who brings the action?
- For actions that settle, at what point in the proceedings does this tend to happen?
- Based on your experience, what is the typical settlement as a percentage of the preference claim? Does it depend on certain factors, and if so, what?

8. (For Debtor's Attorneys) How often do you contact creditors? How do you perceive your role as counsel to a debtor?

Published by University of Oklahoma College of Law Digital Commons, 2019

APPENDIX D

Dear Sir or Madam,

You are being contacted because of your company's involvement in a recent chapter 11 bankruptcy case, ______. I am conducting a research study on the impact of chapter 11 on relationships between debtors and trade creditors. I hope you will consider being part of this research study.

Within the next two weeks, I will attempt to contact you by telephone for an interview. The number I have for you is ______. I am attempting to interview approximately 15 debtors, 30 creditors, and 15 attorneys who can speak generally about their about their experience in chapter 11. I expect our discussion will take about 20 minutes, depending on the length of your responses. I will be recording the conversation for purposes of accurately capturing the information you provide. Your responses will be transcribed, but all information provided will be kept confidential, and your name and personal information will not be used in any way.

You are under no obligation to participate in the research study, however, your participation will provide valuable insight into the experience of debtors and creditors in chapter 11, and how bankruptcy laws might be altered to better achieve the stated goals of bankruptcy. There are no known risks associated with participation, and no costs to you. As part of the research study, you will be asked to recall and describe your experience regarding bankruptcy proceedings that have taken place within the past five years. Depending on your experience, this may bring to mind stressful or unpleasant memories. There is no compensation associated with this study.

Should you have any questions regarding this research study, or if you do not wish to be contacted, please fill out and return the attached form. You may also contact me at (573) 882-3914, or at my email address, gotbergb@missouri.edu. If you have questions regarding your rights as a subject participant, you may contact the Institutional Review Board for the University of Missouri at (573) 882-9585. In addition, if there is a number you would prefer to be contacted at, or a better organizational contact for this inquiry, please provide the information in the form below.

Thank you in advance for your time and consideration.

Sincerely,
Brook Gotberg
Associate Professor
University of Missouri School of Law
203 Hulston Hall, Columbia, MO 65203
(573) 882-3914
gotbergb@missouri.edu

https://digitalcommons.law.ou.edu/olr/vol71/iss4/3