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# Optimal Deterrence and the Preference Gap

Brook E. Gotberg

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*It is generally understood that the way to discourage particular behavior in individuals is to punish that behavior, on the theory that rational individuals seek to avoid punishment. Laws aimed at deterring behavior operate on the assumption that increasing the likelihood of punishment, the severity of punishment, or both, will decrease the behavior. The success of these laws is evaluated by how much the targeted behavior decreases. The law of preferential transfers – which punishes creditors who have been paid prior to a bankruptcy filing at the expense of other, unpaid creditors – has been defended on the grounds that it deters a race to collect from a struggling debtor. However, deterrence theory suggests that the low likelihood of punishment and the cap on punishment associated with preference law make it a very poor deterrence. Further, empirical evidence drawn from interviews with affected creditors, debtors, and attorneys demonstrates that in practice preference law does little or nothing to deter targeted behavior and, in the process, imposes significant costs. The weaknesses of preference law call for its significant revision, to place a greater focus on specific categories of creditors to be punished on account of their pre-bankruptcy activities.*

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## I. INTRODUCTION

Laws that are internally inconsistent in their purpose, their application, and their consequences are inevitably (and accurately) perceived to be unfair by those whom they regulate. So it is with the law of preferential transfers in bankruptcy, which can

negatively affect those who have done business with a debtor and find themselves involved in bankruptcy proceedings as a consequence of the debtor's bankruptcy petition. In any given year, thousands of creditors who have been paid on account of outstanding debts owed by the debtor, or who have otherwise improved their position vis-à-vis the debtor in the ninety days prior to the debtor's bankruptcy petition, are subject to laws mandating the return of those funds to the bankruptcy estate. Although this result is always unpleasant and unwelcome for the liable creditors, it has been justified on two general grounds. First, the mandate of equality in bankruptcy suggests that all unsecured creditors, including those who might have been paid in the ninety-day run up to bankruptcy, should share equally in the pain of discharge by participating in a pro rata distribution of the debtor's available assets.[1] Second, creditors should be deterred from attempting to recover from debtors who are insolvent, thereby hastening the decline into bankruptcy and causing a loss of the debtor's value as a going concern. Under this second rationale, some transfers, particularly those that reflect ongoing business transactions with the debtor, should be protected from preference law, even if doing so undermines the first rationale of equality.

These two explanations for preference law are internally inconsistent, as the first supports the return of all preferential transfers, while the second would differentiate between "good" and "bad" transfers. I have argued elsewhere that, at least in the context of business bankruptcies, Chapter 7 liquidation and Chapter 11 reorganization should be treated differently for purposes of preference law. Preference law should be enforced more stringently in Chapter 7 liquidation to better serve the goal of equal distribution, and abandoned in Chapter 11 reorganizations, where equal distribution is much less emphasized.[2] I have argued

1. Secured creditors generally have their rights to repayment and satisfaction through collateral preserved in bankruptcy, with some exceptions. *See* Lawrence Ponoroff, *Reclaim This! Getting Credit Seller Rights in Bankruptcy Right*, 48 U. RICH. L. REV. 733, 750–52 (2014).

2. *See* Brook E. Gotberg, *Conflicting Preferences in Business Bankruptcy: The Need for Different Rules in Different Chapters*, 100 IOWA L. REV. 51, 59 (2014). This effort to distinguish between bankruptcy chapters has received criticism both from those who argue that it goes too far, see Lawrence Ponoroff, *Bankruptcy Preferences: Recalcitrant Passengers Aboard the Flight*

that preference law is about equality: exceptions to the law purporting to protect "good" transfers undermine efforts to obtain such equality by imposing unnecessary costs on the system.[3] Here, I respond to critics who have asserted that preference law remains essential to deterring undesirable creditor behavior in the days leading up to bankruptcy.

As an initial matter, the concept that law successfully shapes behavior through the principle of deterrence is problematic because deterrence assumes that actors will act rationally, and we know that most will not, at least not all the time.[4] Further, it is unclear that the behavior targeted by preference law is actually problematic enough to be discouraged. Why not allow creditors to collect on their debts, particularly when doing so is in those creditors' own self-interest and entirely legal at the time of collection? Notwithstanding these criticisms, and assuming both that deterrence can actually work and is a worthy goal, I nevertheless conclude that if preference law as currently written fails to truly achieve equal distribution, it is a much bigger failure in deterring bad creditor behavior.

Preference law is flawed as a deterrent for two reasons. First, it is not at all clear what behavior it attempts to discourage. Indeed, different versions of the law have appeared to target dramatically different behaviors over time, and commentators are divided as to the population of creditors or the types of behavior that should be targeted. Second, the law is not an effective deterrence to any population or debt collection efforts. The maximum penalty of a preference is the return of the amount recovered, with most cases settling for a much lower amount. The likelihood of being caught by preference law is also highly uncertain; in fact, most creditors who seek to recover from struggling debtors will never be subject to preference avoidance.

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*from Creditor Equality*, 90 AM. BANKR. L.J. 329, 384 (2016) ("[T]he call for total elimination of preferences in reorganization cases is much like killing the patient in order to halt the spread of the disease."), and those who argue it does not go far enough, see David A. Skeel, Jr., *The Empty Idea of "Equality of Creditors,"* 166 U. PA. L. REV. 699, 729 (2018) (arguing that the equality of creditors norm has largely faded from bankruptcy, and that preference law should reflect this trend by transitioning to a more limited law targeting self-dealing behavior). Such criticisms raise valid concerns regarding complications regarding conversion of a case from one chapter to another; unfortunately there is not space to address these concerns in this Article.

3. *See* Gotberg, *supra* note 2.

4. Owen D. Jones, *The Evolution of Irrationality*, 41 JURIMETRICS J. 289, 314–15 (2001).

As a consequence of these flaws, preference law is rightly viewed as capricious and ineffective. Further, preference law disproportionately imposes its costs on less sophisticated or less aware creditors, frequently smaller businesses who have naively accepted payments from a debtor without any appreciation for their potential future liability. These creditors are typically not familiar with preference law and cannot be deterred by a law of which they are unaware. Better-informed creditors who are familiar with preference law are typically also familiar with its exceptions, and more likely to structure their transactions to fall within an exception. Well-advised creditors can also position themselves to challenge a claim of preference liability should it arise, dramatically reducing their ultimate liability. To the extent informed creditors change their behavior in response to preference law, it is not in a way that benefits debtors; that is, rather than affording debtors additional breathing space in times of financial distress, they reduce the credit they offer to all debtors or insist that such credit be secured.[5] Due to the inherent caps on preference liability, even creditors who fail to raise any colorable defense to preference litigation and are found liable are usually better off having attempted to collect a preference than not.

These criticisms of preference law are established and demonstrated below[6] both by a rational cost-benefit analysis of preference collection, drawing upon prior literature regarding deterrence in the law, and from empirical field work. This Article is the first of its kind to argue that preference law is ineffective as a deterrent of collection behavior based on empirical evidence, drawn from interviews of actors within the field—debtors, creditors, and the attorneys who represented them in bankruptcy proceedings. This Article reports on interviews of sampled

5. For more on how preference law impacts business relationships between debtors and creditors, see Brook E. Gotberg, *It Cuts Both Ways: How Preference Avoidance Actions Can Harm Business Relationships Between Debtors and Creditors* 1 (Univ. Mo. Sch. Law Legal Studies Research Paper Series, Research Paper No. 2018-28, 2018), http://ssrn.com/abstract=3224683.

6. For a discussion of the rational cost-benefit analysis, see *infra* Section II.A, and for the empirical findings, see *infra* Section V.D.

individuals who participated in successful[7] Chapter 11 reorganization cases involving preference actions. The overwhelming and indisputable conclusion from these interviews is that creditors may adjust their behavior in response to preference law, but not in ways that further the purported goal of preference deterrence. Accordingly, if preference law is a law of deterrence, it is wholly ineffectual in its purpose.

From this point forth, this Article assumes that preference law is not aimed at equality among creditors[8] but rather at deterrence.[9] Assuming both that deterrence *can* work and that we *should* have laws deterring collection,[10] preference law would need to be substantially altered to successfully deter. Rather than a blanket imposition of liability on all creditors who have received payments within the ninety days before bankruptcy, liability should be limited to insiders, select secured creditors, and judgment lien creditors. Rather than demanding mere repayment of the preference received, the law should introduce a meaningful penalty to discourage these creditors from acting to undermine a debtor's potential for reorganization in the days prior to bankruptcy. Stereotypical unsecured creditors do not have the power to negatively impact a debtor's chances of reorganization in a meaningful way, and so should not be targets of the law for the sake of deterrence. Further, the current scheme does not deter them from attempting to recover whatever they can in the days prior to bankruptcy. Accordingly, for purposes of deterrence the law should cease to apply to such creditors.

The Article will proceed as follows. Part II clarifies what it means for a law to act as a deterrent, demonstrating how deterrence works in criminal and in civil proceedings, and provides a brief

7. As in many analyses of Chapter 11 cases, success here is defined as obtaining a confirmed plan in Chapter 11. *See* Elizabeth Warren & Jay Lawrence Westbrook, *The Success of Chapter 11: A Challenge to the Critics*, 107 MICH. L. REV. 603, 610–12 (2009).

8. Equality of distribution has long been considered the central goal of bankruptcy, although its primacy has recently come under attack. *See* Skeel, *supra* note 2.

9. I do not advocate this position but rather stand by the perspective I outlined in Gotberg, *supra* note 2. This Article is intended largely to demonstrate the flaws inherent in treating preference law as a law of deterrence, rather than equality. Insofar as the law continues to satisfy both goals, the recommendations found herein are inconsistent with the goal of equality.

10. I make these assumptions purely for the sake of argument. I have reservations regarding the first assumption and am wholly unpersuaded of the second.

summary of how the theory of deterrence has been criticized. Part III explains preference law in the bankruptcy context and how it can be said to deter creditors. Part IV demonstrates how preference law fails to successfully identify targeted behavior. Part V uses a cost-benefit model to demonstrate how preference law fails to meaningfully deter, because the likelihood of liability is low and the penalty associated with a preference is limited to the amount of the original transfer. This Part is further supported by empirical findings that reinforce the theoretical conclusions of the cost-benefit model. Part VI proposes amendments to the preference laws that would respond to these findings. It suggests ways in which the law could more closely target specific behaviors, while largely reserving judgment on whether such behaviors should be targeted at all. Part VII concludes.

## II. DETERRENCE

### *A. What Does It Mean to Deter?*

A major tool of the law in shaping the behavior of its citizens is discouraging certain behavior by penalizing it. The principle of legal deterrence operates on the assumption that rational actors will examine the costs and benefits of engaging in any given behavior. If the costs imposed by the penalty outweigh the benefits of engaging in the behavior, they will choose not to engage in it. The law typically deters by increasing costs associated with certain behavior through punishment such as incarceration or monetary sanctions, although conceivably, the law could accomplish the same effect by reducing the benefits of the targeted behavior. Scholars often attempt to evaluate the deterrent effect of a given law by tracking measurements of behavior before and after the law comes into effect.

Although deterrent laws are deemed efficient or inefficient depending on their success in reducing the undesirable behavior, not all deterrents are judged on the same standard of success. Behavior that is more despicable requires a less efficient deterrent to justify the imposition of costs; for example, most would probably agree that laws attempting to deter murder are justified, even if

they are relatively inefficient in preventing murders.[11] On the other hand, laws that are inefficient at preventing smaller infractions (for example, turnstile jumping) may be less justifiable, as costs of enforcement outweigh the benefits of deterrence.[12]

Some may object generally to use of cost-benefit analysis as a method of evaluating the benefits of a particular policy, in part because they disagree with utilitarianism as an ultimate goal or because such an analysis may be difficult to accomplish and therefore prove unreliable.[13] However, the concept of deterrence inherently invites such an analysis, because it assumes that individuals subject to the law adopt a utilitarian approach by which they adjust their behavior. Laws that are justified on the grounds of deterrence have accordingly wed themselves to a utilitarian approach. Under this approach, laws that efficiently discourage the targeted behavior are good and should be enacted and upheld, and laws that do not efficiently discourage the targeted behavior are bad and should be abandoned.

This approach is subject to challenge insofar as the analysis relies on a theoretical calculation of efficiency rather than a real-world application. The theory of deterrence necessarily assumes that individuals who would be deterred by the punishment associated with the law are rational actors who engage in a rational analysis with all relevant facts. Obviously, insofar as these assumptions are incorrect, the analysis is imperfect. Actors cannot be deterred by laws of which they are unaware, and actors who do

11. The conversation regarding the death penalty as a deterrence is illustrative. *See* John J. Donohue & Justin Wolfers, *Uses and Abuses of Empirical Evidence in the Death Penalty Debate*, 58 STAN. L. REV. 791, 792–94 (2005) (finding that evidence of deterrence is surprisingly fragile); Ernest van den Haag, *The Ultimate Punishment: A Defense*, 99 HARV. L. REV. 1662, 1666 (1986) ("Sparing the lives of even a few prospective victims by deterring their murderers is more important than preserving the lives of convicted murderers because of the possibility, or even the probability, that executing them would not deter others.").

12. *See* Maura Ewing, *Will New York Stop Arresting People for Evading Subway Fares?*, ATLANTIC (Aug. 4, 2017), https://www.theatlantic.com/politics/archive/2017/08/new-york-subway-fares/535866/ (noting that Manhattan District Attorney Cy Vance recently announced the office would stop prosecuting fare beating); Ryan Kailath, *New York Won't Arrest You for Stealing a Subway Ride Anymore*, MARKETPLACE (Aug. 31, 2017, 5:47 AM), https://www.marketplace.org/2017/08/31/economy/new-york-wont-arrest-you-stealing-subway-ride-anymore (noting that New York City's Independent Budget Office estimated that prosecuting fare evasion cost $2,458 per arrest not including detention costs, while allowing free subway access would cost only a tenth of that).

13. *See generally* Robert H. Frank, *Why Is Cost-Benefit Analysis So Controversial?*, 29 J. LEGAL STUD. 913 (2000) (addressing common objections to a cost-benefit analysis).

not engage in a utilitarian analysis will not respond as anticipated to a given law. Accordingly, laws which are poorly understood, counterintuitive, or ignored by the public will prove more efficient in theory than they are in practice. Any model that seeks to accurately calculate the deterrent effect of a given law must factor in the extent to which the law is incorporated into decision-making processes.

Further, the baseline assumption of deterrence theory is that individuals will operate rationally to maximize their own objective benefit (the rational choice assumption). Even champions of the law and economics approach have recognized that "[t]here is simply too much credible experimental evidence that individuals frequently act in ways that are incompatible with the assumptions of rational choice theory" for it to stand as a justification alone and without modification.[14] One of the purported benefits of the rational choice theory is its simplicity; this simplicity also limits its ability to predict behavior.[15] Accordingly, an evaluation of a law's deterrent effect, to be truly accurate, would need to take into account both the theoretical estimation of the law's influence on behavior and also evidence of actual responsive behavior.

For purposes of this Article, I assume that it is possible to effectively deter behavior and that deterrence may generally be predicted according to a cost-benefit analysis, incorporating a rational choice assumption.[16] I evaluate preference law accordingly. I assume both that creditors act rationally, at least when engaging

14. Russell B. Korobkin & Thomas S. Ulen, *Law and Behavioral Science: Removing the Rationality Assumption from Law and Economics*, 88 CAL. L. REV. 1051, 1055 (2000) (arguing for a "law and behavioral science" approach that would seek to understand the incentive effects of a law by drawing on psychological and sociocultural theories); *see also* David J. Arkush, *Situating Emotion: A Critical Realist View of Emotion and Nonconscious Cognitive Processes for Law and Legal Theory*, 2008 BYU L. REV. 1275 (2008) (arguing that emotion plays a role in most if not all decisions and is not readily amenable to maximization); Korobkin, *supra* at 1058; Richard A. Posner, *Rational Choice, Behavioral Economics, and the Law*, 50 STAN. L. REV. 1551, 1554 (1998) (recognizing that "cognitive quirks" such as "the availability heuristic, overoptimism, the sunk-cost fallacy, loss aversion, and framing effects" will inform rational choice, but arguing that the fact that people are not always rational is not in itself a challenge to rational choice economics because it can be accounted for in models).

15. Robert H. Frank, *Commitment Problems in the Theory of Rational Choice*, 81 TEX. L. REV. 1789, 1790 (2003) (arguing for an alternative to the standard of rationality, which produces predictions that often turn out to be flatly incorrect).

16. I do not concede this point for at least two reasons. First, citizens are unlikely to be aware of the laws which ostensibly deter their behavior, and second, rational choice assumption is only marginally accurate in predicting behavior.

in business transactions giving rise to preference claims, and that creditors are solely incentivized to maximize their overall wealth, represented only in dollars. I therefore allow that a law which exacts a dollar cost from individuals for a given action is likely to discourage individuals from acting when the cost imposed by the law exceeds the dollar benefit of that action. Nevertheless, I conclude that preference law as written neither successfully identifies the actions it wishes to discourage nor imposes a sufficient cost to deter those actions. In support of this conclusion, I first lay out the theoretical underpinnings of deterrence.

### *B. Becker's Theory of Deterrence*

Gary S. Becker may justifiably be viewed as the father of the economic model of deterrence. The principles underlying his theory of criminal deterrence have been widely tested, both in and out of the criminal law context. Becker's seminal paper examining the costs and benefits of incarcerating criminals was first published in 1968.[17] In it, he suggested that the number of criminal offenses a person will engage in depends on such variables as (1) the probability of conviction, (2) the punishment if convicted, and (3) a "portmanteau" of other influences such as personal willingness to commit an illegal act, income available in legal and other illegal activities, and the frequency of nuisance arrests. He represented this thought by a simple equation:

$$O_i = O_i(p_i, f_i, u_i),$$

with $O$ representing the number of offenses, $p$ the probability of conviction per offense, $f$ the punishment per offense, and $u$ all other variables.[18] He reasoned that increases in any variable ($p$, $f$, or $u$) would tend to reduce the number of offenses, as the probable cost for each offense would grow with the likelihood of apprehension or cost of the penalty.[19] Becker further argued that, in light of the costs to society associated with the imprisonment of offenders,

17. Gary S. Becker, *Crime and Punishment: An Economic Approach*, 76 J. POL. ECON. 169 (1968).

18. *Id.* at 177.

19. *Id.*

a better punishment would be to impose a series of fines whenever feasible.[20]

Since Becker's publication, multiple authors have adopted and tested this utility approach to criminal deterrence using empirical data in a variety of contexts.[21] The associated formula has been altered to better emphasize the cost/benefit nature of the analysis as follows:

$$E(U) = (1-p)\,U(y) + p\,U(y-F),$$

where $E(U)$ is the actor's expected utility from an action, $p$ is the likelihood of being punished, $y$ is the anticipated returns from the activity, and $F$ is the anticipated penalty if the actor is punished.[22] Under this formula, an actor's likely utility ($U$) will be positive whenever the returns from the activity exceed the punishment associated with the activity, which is informed by how likely the actor is to be caught and punished. As pointed out by Irving Piliavin et al., an actor's decision whether to engage in the activity will theoretically be informed by the expected rewards and costs as subjectively perceived by the actor, rather than their objective reality.[23] This approach acknowledges that actors will act based on

20. *Id.* at 193.

21. *See, e.g.*, David S. Abrams, *Estimating the Deterrent Effect of Incarceration Using Sentencing Enhancements*, 4 AM. ECON. J. 32 (2012) (finding lower crime rate in states with enhanced punishments for committing crimes with a firearm); Gregory DeAngelo & Benjamin Hansen, *Life and Death in the Fast Lane: Police Enforcement and Traffic Fatalities*, 6 AM. ECON. J. 231 (2014) (finding that a decrease in enforcement via traffic citations is associated with a significant increase in injuries and fatalities caused by traffic accidents); Francesco Drago et al., *The Deterrent Effects of Prison: Evidence from a Natural Experiment*, 117 J. POL. ECON. 257 (2009) (finding in a study of Italian prisons that one month less time served in prison in exchange for one month more in expected sentence for future crimes had a negative impact on the probability of recidivism); Benjamin Hansen, *Punishment and Deterrence: Evidence from Drunk Driving*, 105 AM. ECON. REV. 1581, 1608 (2015) (finding evidence that a 10 percent increase in sanctions and punishments is associated with a 2.3 percent decline in drunk driving in the state of Washington); Eric Helland & Alexander Tabarrok, *Does Three Strikes Deter?: A Nonparametric Estimation*, 42 J. HUM. RESOURCES 309 (2007) (finding lower recidivism rates among convicts facing life in prison if convicted of a third strike in California); David S. Lee & Justin McCrary, *The Deterrence Effect of Prison: Dynamic Theory and Evidence* 1 (Princeton Univ., Dep't Econ., Ctr. Econ. Policy Studies, Working Paper No. 1168, 2009) (finding minimal response by youth to the large change in penalties for crimes when they reach the age of eighteen).

22. Irving Piliavin et al., *Crime, Deterrence, and Rational Choice*, 51 AM. SOC. REV. 101, 101-02 (1986).

23. *Id.* at 102.

what they believe, rather than what is true. However, it remains the case that "[a] utility approach—like so much deterrence theorizing—assumes rationality in the decision to commit a crime."[24] Assuming rationality in the criminal context may be a fundamental error.

### *C. Broader Application*

The rational choice assumption underpinning this deterrence theory may be easier to defend in the civil context, where it has also been applied. Concepts of deterrence arise frequently in discussions of punitive damages, which may be awarded upon a finding of liability in tort. Punitive damages are typically justified on one or both of two grounds: first, that they may be necessary to achieve fairness in punishing a wrongdoing, and second, that they deter undesirable behavior.[25] The first justification appeals to a sense of moral desserts, and the second to an efficiency analysis. With regards to the deterrence justification, punitive damages can only be viewed as necessary to the extent that ordinary compensatory damages do not sufficiently discourage inappropriate behavior.[26] What is more, because the possibility of punitive damages can increase litigation costs, the use of punitive damages can only be defended if the good to be obtained—deterrence—outweighs those costs.[27]

In evaluating the efficiency of punitive damages as a means of deterrence, Dorsey Ellis has concluded that in most instances punitive damages are overkill because "[c]ompensatory damages ordinarily would appear to be sufficient to promote efficient levels of deterrence."[28] Indeed, some scholars, including Gary Schwartz, have argued that a primary purpose of tort liability as a whole, with its basic theory of damages, is to deter inappropriate behavior.[29]

24. Herbert Jacob, *Rationality and Criminality*, 59 SOC. SCI. Q. 584, 584 (1978).

25. *See* Dorsey D. Ellis, Jr., *Fairness and Efficiency in the Law of Punitive Damages*, 56 S. CAL. L. REV. 1, 11 (1982) (distilling the purposes for punitive damages cited in judicial opinions and writings of commentators into punishment and deterrence).

26. *See* Gary T. Schwartz, *Deterrence and Punishment in the Common Law of Punitive Damages: A Comment*, 56 S. CAL. L. REV. 133, 137 (1982) (noting that the primary purpose of tort liability itself is to deter inappropriate behavior by accident causers).

27. *See* Ellis, *supra* note 25, at 46.

28. *Id.* at 9.

29. Schwartz, *supra* note 26, at 137; *see also* Gary T. Schwartz, *Mixed Theories of Tort Law: Affirming Both Deterrence and Corrective Justice*, 75 TEX. L. REV. 1801, 1801 (1997) (identifying

Schwartz cites Richard Posner, who has argued that the Learned Hand formula of negligence represents an attempt to ensure efficiency in accident prevention by encouraging potential tortfeasors to engage in a cost-benefit analysis, whereby they would prevent accidents when compensatory damages exceed the costs of prevention, but not otherwise.[30] In other words, a tortfeasor should endeavor to prevent torts when the cost of prevention does not exceed the damages necessary to make a victim whole. On the other hand, if the costs of prevention exceed compensatory damages, tortfeasors should internalize those costs but not be required to engage in prevention. In addition, to the extent that a victim would be better placed to prevent harm (by taking due care) the tortfeasor should not be liable for costs associated with the victim's own negligence.[31] Posner does note that greater punishment (imposing of costs that exceed the victim's damages) may be "necessary where the violator is frequently not apprehended, because a rational lawbreaker will discount the gravity of any legal sanction by the probability that it will be imposed."[32]

Preference liability is not directly analogous to either punitive damages or criminal behavior, but insofar as the law is intended to deter behavior, it lends itself to similar theoretical evaluation. As explained in greater depth below, actions giving rise to preference liability are highly unlikely to be punished (or even punishable) and the punishment typically meted out is significantly below the benefit received, or at most, equal to it. In practice, enforcement of preference law as a deterrence also raises additional concerns not addressed in the classic Becker model of deterrence, such as awareness of the law and the ability to weigh its likely consequences in making a decision.

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tort scholars as either in the camp of tort liability as an instrument of deterrence or as a way of achieving corrective justice).

30. Richard A. Posner, *A Theory of Negligence*, 1 J. LEGAL STUD. 29, 32 (1972) ("Hand was adumbrating, perhaps unwittingly, an economic meaning of negligence.").

31. *Id.* at 39.

32. *Id.* at 41.

## III. PREFERENCE LAW

### *A. Preference Liability and Defenses*

As one attorney makes a point of explaining to his clients, preference liability is a matter of timing, not of intent or culpability.[33] Indeed, preference liability today[34] has no explicit intent requirement on either the part of the debtor (to prefer the creditor over others) or the creditor (to come ahead of other creditors in repayment).[35] Rather, qualification of a given transfer as "preferred" depends on whether it was (1) to or for the benefit of a creditor; (2) on account of an antecedent debt; (3) made while the debtor was insolvent; (4) during the preference period, generally ninety days before the bankruptcy filing;[36] and whether it resulted (5) in the recipient receiving more than it would have had the transfer not been made and the estate liquidated pursuant to Chapter 7.[37] Accordingly, otherwise entirely legal transactions

33. *See* Telephone Interview with CA (May 18, 2017) ("[I]t's got nothing to do with whether or not you did something wrong or right. It's got everything to do with timing."). Reference to statements by attorneys and creditors are drawn from interviews collected by this author as part of a research study examining the impact of Chapter 11 bankruptcy proceedings on business relationships between debtors and creditors. This study involved a total of 48 interviews from debtors, creditors, and their attorneys involved in a total of fourteen confirmed Chapter 11 cases closed sometime between August 30, 2010, and February 1, 2017, where preference actions had been filed against otherwise unsecured trade creditors. All interview transcripts have been stripped of identifying material and are on file with the author. *See also* discussion on *Empirical Findings infra* Section V.D.

34. The modern view of preference law as a law of strict liability was introduced in 1978 with the enactment of the Bankruptcy Code. Prior to that time, every version of American bankruptcy legislation included an element of intent. *See* Lawrence Ponoroff, *Evil Intentions and an Irresolute Endorsement for Scientific Rationalism: Bankruptcy Preferences One More Time*, 1993 WIS. L. REV. 1439, 1478 (1993) [hereinafter *Bankruptcy Preferences One More Time*].

35. *See* John C. McCoid, II, *Bankruptcy, Preferences, and Efficiency: An Expression of Doubt*, 67 VA. L. REV. 249, 259 (1981); *see also In re* Hall, 4 AM. BANKR. REP. ANN. 671, 678 (1900) (critiquing the statutory move away from the intent requirement); Robert Weisberg, *Commercial Morality, the Merchant Character, and the History of the Voidable Preference*, 39 STAN. L. REV. 3, 89–90 (1986) (discussing Referee Hotchkiss's critique of the system in In re *Hall*).

36. For insiders, the preference period is extended to one year before the bankruptcy filing. *See* 11 U.S.C. § 547(b)(4) (2012).

37. *See* 11 U.S.C. § 547. Any transfer prior to the bankruptcy will satisfy the requirement that the recipient be better off as a consequence when the creditor would have received less than 100% in a Chapter 7 payout. *See* Savage & Assocs., P.C. v. Mandl (*In re* Teligent Inc.), 380 B.R. 324, 339 (Bankr. S.D.N.Y. 2008); Vern Countryman, *The Concept of a Voidable Preference in Bankruptcy*, 38 VAND. L. REV. 713, 736–37 (1985). The full text of § 547(b) reads as follows:

between the debtor and creditor become subject to preference avoidance based entirely on when they occurred. Put another way, if the debtor transfers funds to a non-insider creditor on account of a legitimate debt, and then files for bankruptcy ninety-one days later, there are no legal ramifications. If the same transfer occurs eighty-nine days before a bankruptcy filing, the creditor may be liable to return the full amount to the bankruptcy estate. This law applies to all creditors in every bankruptcy case, whether it be consumer or commercial, reorganization or liquidation. Accordingly, preference actions may be brought by a trustee in Chapter 7, 11, or 13,[38] but also by the debtor itself in Chapter 11 acting as a debtor-in-possession (DIP).[39]

Preference liability is subject to a variety of possible defenses,[40] which lack a comprehensive rationality and instead respond to a myriad of legislative aims.[41] The most hotly litigated defense to

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(b) Except as provided in subsections (c) and (i) of this section, the trustee may avoid any transfer of an interest of the debtor in property—

(1) to or for the benefit of a creditor;

(2) for or on account of an antecedent debt owed by the debtor before such transfer was made;

(3) made while the debtor was insolvent;

(4) made—

(A) on or within 90 days before the date of the filing of the petition; or

(B) between ninety days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider; and

(5) that enables such creditor to receive more than such creditor would receive if—

(A) the case were a case under chapter 7 of this title;

(B) the transfer had not been made; and

(C) such creditor received payment of such debt to the extent provided by the provisions of this title.

11 U.S.C. § 547(b).

38. *See id.* §§ 704, 1106, 1302. A trustee appointed under Chapter 12, a less commonly used chapter in the Bankruptcy Code, may also bring a preference claim. *See id.* § 1202.

39. *See* 11 U.S.C. § 1107 (1984).

40. These exceptions to preference liability are listed in 11 U.S.C. § 547(c)(1)–(9) (2012). Only some of the exceptions are discussed here.

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

preference liability is the so-called "ordinary course" defense.[42] Under this exception, no liability attaches when the incurrence of the debt is made in the ordinary course of business and the payment of that debt is also made in the ordinary course of business or according to ordinary business terms.[43] The ordinary course exception, being highly subjective, encourages litigation by requiring the interpretation of an impartial fact finder as to what is "ordinary." This exception is frequently identified as support for the argument that preference law is intended to deter, as the exception seems to limit preference recovery to situations involving "non-ordinary" or unusual collection efforts.[44] As explained below, this argument is problematic, but the ordinary course exception nevertheless remains the poster child for preference law as deterrence.

The next most commonly invoked exception for preference defendants is the new value defense.[45] This defense permits creditors to avoid preference liability to the extent to which they have transferred new value to the debtor subsequent to accepting the preference. For example, suppose that on the eightieth day before bankruptcy the debtor paid a creditor $10,000 on account of a previous $20,000 balance. The creditor subsequently shipped an

42. Lawrence Ponoroff & Julie C. Ashby, *Desperate Times and Desperate Measures: The Troubled State of the Ordinary Course of Business Defense – and What to Do About It*, 72 WASH. L. REV. 5, 7 n.3 (1997) ("The ordinary course of business exception is by far the most litigated of the § 547(c) preference defenses and has been the source of keen interest to commentators."). There is some suggestion in the mark-up minutes of the House subcommittee staff for the original language of the exception, which contained the forty-five-day lookback limitation, that it was also intended to set aside those payments for which debts were not truly "antecedent," similar to the substantially contemporaneous exception. *See* Lissa Lamkin Broome, *Payments on Long-Term Debt as Voidable Preferences: The Impact of the 1984 Bankruptcy Amendments*, 1987 DUKE. L.J. 78, 98 n.97 (1987) (quoting *Minutes of the Subcomm. on Civil and Constitutional Rights of the House Comm. on the Judiciary*, 95th Cong., 1st Sess. 553 (1977) (statement of Mr. Kenneth Klee)). Subsequent amendments to the provision have removed the possibility that it serves such a purpose. *See* discussion *infra* notes 63–65 and accompanying text.

43. 11 U.S.C. § 547(c)(2) (2012). The statute required a showing that a transfer was *both* made in the ordinary course of business *and* according to ordinary business terms until 2005, when the and was replaced with "or." *See* Charles J. Tabb, *The Brave New World of Bankruptcy Preferences*, 13 AM. BANKR. INST. L. REV. 425, 428 (2005) [hereinafter *Brave New World*].

44. *See* A. Ari Afilalo, *The Impact of* Union Bank v. Wolas *on the Ordinary Course of Business Defense to a Trustee's Avoiding Powers*, 72 B.U. L. REV. 625, 635 (1992) (explaining that the ordinary course of business exception is ultimately aimed at deterrence, not equality of distribution).

45. 11 U.S.C. § 547(c)(4) (2012).

additional $5,000 worth of goods to the debtor. Upon a bankruptcy filing, the creditor would be liable for a preference of $10,000 but would have a new value defense for the $5,000 of new value subsequently transferred to the debtor. The new value defense only applies to subsequent transfers to the debtor. In other words, had the creditor given the debtor the $5,000 of goods prior to the $10,000 payment, there would be no defense. In theory, the defense is available to those creditors who have continued to assist the debtor by providing credit in the days leading up to bankruptcy.

Pursuant to the definition of a "transfer," preference liability may attach to the grant of a security interest. In other words, a creditor who signs a security agreement with the debtor within the ninety days before bankruptcy to secure a pre-existing debt may be subject to preference liability. However, purchase money security interests are excepted from preference liability when perfected within thirty days of the debtor receiving possession of the collateral,[46] and statutory liens (such as mechanic's liens or other security interests granted by operation of law) are also excepted from preference liability.[47] Smaller transfers may be excepted from liability by way of a statutory minimum.[48] For business cases, this minimum is around $6,000;[49] for consumer cases it is around $600. Amendments to the Code in 2005 establishing venue rules for preference actions have also operated as a type of exception, by virtue of discouraging preference actions against an out-of-state creditor whose liability falls below a certain amount. In such cases, the creditor may only be sued in its own venue, which may discourage a trustee or DIP from bringing the claim by virtue of the additional costs associated with prosecuting a case out of state.[50]

Although not a delineated exception to the rule, perhaps the most common and relevant exception to preference liability is made for wholly secured creditors. Any payments made to creditors supported by a security interest in collateral that exceeds the value of the debt will not be preferential transfers, because under

46. *Id.* § 547(c)(3).
47. *Id.* § 547(c)(6).
48. *Id.* § 547(c)(8)-(9).
49. *Id.*
50. *See Brave New World*, *supra* note 43, at 428. For more on the impact of venue provisions, see *infra* note 114.

bankruptcy law such creditors are assured that they will receive the full value of their claim. Accordingly, a secured creditor who receives payments against the debt in the days before bankruptcy would not receive any more than they would absent the transfer in a case under Chapter 7. As a consequence, creditors with the most leverage over the debtor and the best ability to force repayment are not subject to preference liability. That said, creditors who attempt to become secured just prior to bankruptcy may have that security revoked, as explained above.[51] Similarly, judgment creditors who successfully execute a lien against the debtor's property within the ninety days prior to a bankruptcy filing, but do not complete the foreclosure process by the time of filing, may also be required to give up their lien as a preferential transfer.[52]

Liability for preference may result in a court order and a judgment against the creditor, although only a small percentage of preference actions ever make it to trial. Although data is difficult to gather on the subject, it is thought that a significant minority of actions are settled before any court filings are made, and many more are settled after the complaint is filed but before an answer is due.[53] The remainder are generally handled on summary judgment. Creditors who refuse to settle a filed preference complaint or repay pursuant to a court judgment will have any claim against the debtor's estate disallowed, and accordingly will receive nothing in the estate payout for sums they may still be owed by the debtor.[54]

### *B. Legislative Rationale for Preference Law as Deterrence*

As a deterrent to collection on pre-existing debts, preference law runs directly counter to non-bankruptcy law in terms of

51. *See supra* prior paragraph.

52. Whether or not the lien will be considered an avoidable preference will depend in part upon the state law's determination of when the lien becomes perfected, and in part on the Bankruptcy Code's statutory definition of a transfer. *See, e.g.*, Redmond v. Mendenhall, 107 B.R. 318, 321–23 (D. Kan. 1989).

53. *See* CHARLES JORDAN TABB, AM. BANKR. INST., ABI PREFERENCE SURVEY REPORT 8 (1997) [hereinafter ABI PREFERENCE SURVEY].

54. 11 U.S.C. § 502(d) (2012). In some cases, this appeared to be a deliberate strategy for the debtor. *See* Telephone Interview with CA (Aug. 8, 2017) ("We never expected, necessarily, to recover a whole bunch of money but just disallowing their claim because they were the holder of an avoided transfer and didn't pay it. . . . [T]hat was a motivating factor at times.").

creditor incentives. Current state law legal regimes award creditors who are first to collect and provide no minimum recovery for slower creditors. In fact, the judicial system encourages creditors to bring their claims within a reasonably prompt time period, or risk losing their claims for repayment to the statute of limitations.[55] If a creditor is successful in collecting from the debtor, this leaves the debtor with less cash, and a reduced ability to satisfy the claims of others or to maintain ongoing operations. Accordingly, creditor collection can prompt the need for a bankruptcy filing. The reasoning behind preference law is that if a creditor knows that successful collection efforts may be undone in the bankruptcy proceedings, the creditor will be less inclined to collect and more inclined to wait.[56] The debtor will benefit by virtue of this "breathing room" and, if all goes well, may be able to overcome the difficulties that lead to insolvency without the assistance of the bankruptcy court. If this happens, all creditors benefit.

The legislative history of the Bankruptcy Code points to Congressional perception that the race of creditors to collect should be discouraged, at least in cases where bankruptcy is a possibility. Preference law was expressly conscripted as the tool to deter such a race.[57] By specifically referencing a "rac[e] to the courthouse" in discussion of preference law,[58] the legislative history suggests that Congress was primarily concerned with creditors attempting to edge each other out by obtaining a judicial lien over the debtor's property, or the functional equivalent, before other creditors could do so. It is worth noting that typical unsecured creditors cannot force a debtor to make a payment without invoking judicial

55. For example, the State of Missouri requires all actions upon contracts to be brought within five years, MO. REV. STAT. § 516.120 (2015), and South Carolina only permits such actions to be brought within three years. S.C. CODE ANN. § 15-3-530 (2015).

56. *See* Ponoroff, *supra* note 2, at 344.

57. *See* S. REP. NO. 95-989, at 88 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5874 (the general policy of preference law is deterring "unusual action" by the debtor or creditors); H.R. REP. NO. 95-595, at 177–78 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6138 ("[B]y permitting the trustee to avoid prebankruptcy transfers that occur within a short period before bankruptcy, creditors are discouraged from racing to the courthouse to dismember the debtor during his slide into bankruptcy."); H.R. DOC. NO. 93-137, at 202 (1973) ( "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.").

58. H.R. REP. NO. 95-595, at 177–78.

process, although creditors may vary in their ability to encourage repayment based on other factors, such as the debtor's need for ongoing creditor services or the need to maintain its reputation with the creditor.[59]

From an insolvent debtor's perspective, it can be extraordinarily harrying to manage the collection efforts of multiple creditors at a time when the debtor lacks the ability to repay all of its debts simultaneously. This activity can have a deleterious effect on the debtor's ability to run its business. Further, there is the concern that efforts to collect may prompt what might be described as a "run on the bank," with all creditors losing confidence simultaneously, obtaining judgments, seizing debtor assets, and obliterating any possibility that the debtor can make good on its claims to all.[60] One of the motivating elements of the automatic stay in bankruptcy is to prevent further collection efforts not only to ensure that a given creditor cannot enrich itself at the expense of others but also to provide the debtor with the breathing room necessary to make an effectual comeback.[61] Preference law, as a deterrence, seeks to advance "the corresponding goal" of encouraging breathing room prior to the filing.[62]

59. An effort to seize the debtor's property without first obtaining a judgment lien or garnishment order would constitute the tort of conversion and open the creditor to liability. *See* Okyere v. Palisades Collection, LLC, 961 F. Supp. 2d 522, 534 (S.D.N.Y. 2013) ("A conversion takes place when someone, intentionally and without authority, assumes or exercises control over personal property belonging to someone else, interfering with that person's right of possession."); Charles W. Mooney, Jr., *A Normative Theory of Bankruptcy Law: Bankruptcy As (Is) Civil Procedure*, 61 WASH. & LEE L. REV. 931, 1023 (2004) ("Under nonbankruptcy law, unsecured creditors have no property interest in their debtor's assets until such time as they receive a judicial lien, normally following judgment and, as to personal property, the exercise of judicial remedies against the debtor's assets.").

60. *See In re* Tolona Pizza Prods. Corp., 3 F.3d 1029, 1032 (7th Cir. 1993) ("Unless the favoring of particular creditors is outlawed, the mass of creditors of a shaky firm will be nervous, fearing that one or a few of their number are going to walk away with all the firm's assets . . . .").

61. *See In re* Anderson, 913 F.2d 530, 533 (8th Cir. 1990) (stating courts should be reticent to infringe on the breathing room afforded a debtor in Chapter 11 by Congress); *see generally* H.R. REP. NO. 95-595, 95th Cong., 1st Sess. 340 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5963, 6296–97.

62. *Bankruptcy Preferences One More Time*, *supra* note 34, at 1479 ("The corresponding goal of the preference law [is] deterring a frenzied pre-bankruptcy scramble to dismember the debtor's estate . . . ."). It is worth noting that Professor Ponoroff further argued that this goal was difficult to defend in light of the change in law removing any intent requirement, and suggested that preference law was unlikely to have much of a deterrent effect. *Id.*

Consistent with concerns over a race to collect through use of the judicial process, rather than what might be considered the ordinary amble of debt collection among creditors, Congress enacted the ordinary course exception to protect "normal" debt payments from liability, thereby more directly targeting "racing" behavior.[63] Although what is "normal" is never fully defined, it presumably would not include demands for payment of past-due debts, whether or not such demands are accompanied by judicial action.[64] As originally passed, the ordinary course exception was limited to the payment of a debt made in the ordinary course of business within forty-five days of the debt's incurrence.[65] As stated in the House and Senate Reports, "[t]he purpose of [the forty-five-day ordinary course exception] is to leave undisturbed normal financial relations, because it does not detract from the general policy of the preference section [which is] to discourage unusual action by either the debtor or his creditors during the debtor's slide into bankruptcy."[66] The forty-five-day language was later removed from the exception in the 1984 amendments in response to testimony that normal payment periods often exceeded forty-five days.[67] Following that change, the Supreme Court ruled in *Union Bank v. Wolas* that interest payments on a seven-million-dollar loan pursuant to a revolving credit agreement fell within the ordinary course exception.[68] This ruling startled many who considered the

63. *See* Fiber Lite Corp. v. Molded Acoustical Prods., Inc. (*In re* Molded Acoustical Prods., Inc.), 18 F.3d 217, 224-25 (3d Cir. 1994) (citing O'Neill v. Nestle Libbys P.R., Inc., 729 F.2d 35, 37 (1st Cir. 1984)) ("Bankruptcy policy, as evidenced by the very existence of § 547(c)(2), is to promote . . . continuing relationships on level terms, relationships which if encouraged will often help businesses fend off an unwelcome voyage into the labyrinths of a bankruptcy.").

64. *But see* Darrell Dunham & Donald Price, *The End of Preference Liability for Unsecured Creditors: New Section 547(c)(2) of the Bankruptcy Code*, 60 IND. L.J. 487, 500 (1985) (suggesting that the ordinary course exception could be interpreted to encompass all business-related transactions).

65. *See* 11 U.S.C. § 547(c)(2) (1982), *amended by* Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, tit. III, sec. 462(c), 98 Stat. 333, 378.

66. S. REP. NO. 95-989, at 88 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5874; H.R. REP. NO. 95-595, at 373 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6329; *see also* Broome, *supra* note 42, at 98-99 (noting that the forty-five-day period appeared to be selected on the basis of a one-month normal billing cycle).

67. *See* Broome, *supra* note 42, at 100-05 (describing complaints made to Congress on behalf of trade creditors, commercial paper issuers, and consumer lenders).

68. Union Bank v. Wolas, 502 U.S. 151, 162 (1991).

opinion a clear deviation from the intended scope of the exception.[69] Under current law, therefore, preference liability is nominally limited to those transfers that cannot be characterized as falling within the ordinary course of business or having been made according to ordinary business terms.

The ordinary course exception is a defense which must be raised and supported by the defending creditor in a contest of preference liability. There is no requirement on the part of the trustee or the DIP to establish the lack of such a defense before bringing the claim. Accordingly, even those creditors who fall within the ordinary course exception are vulnerable to a claim by the trustee and may thus be obligated to expend time and energy in defending that claim, either to the trustee in settlement negotiations or before the court in trial. The necessity of bringing an affirmative defense is relevant in determining the deterrent power associated with preference law, discussed in greater depth below.

There is some indication in the discussion of lawmakers that deterrence is a secondary goal of preference law, with the primary goal being equal distribution among creditors.[70] Multiple scholars have adopted this approach and criticized elements of preference

69. *See* Broome, *supra* note 42 at 121 (arguing that the legislative history of § 547(c)(2) evinces that Congress intended the exception to be limited to payments to trade creditors, not payments on long-term debt); Peter A. Davidson, *ZZZZ Best – Ordinary Course Protection for Long-Term Debt*, 20 CAL. BANKR. J. 45, 45 (1992) ("The Court's decision, however, should not come as a surprise to anyone who has paid heed to the Court's recent, strict constructionist theme."); Debbi L. Rauanheimo, *Case in Controversy – Section 547(c)(2) Remains Uncertain After* ZZZZ Best, 1 J. BANKR. L. & PRAC. 419, 419 (1992).

70. *See* H. REP. NO. 95-595, at 177–78 ("The purpose of the preference section is two-fold. First, by permitting the trustee to avoid prebankruptcy transfers 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."); Broome, *supra* note 42, at 115 (noting that, after 1978, the main goal of preference law was to preserve equality of distribution, with deterrence only an incidental objective); Countryman, *supra* note 37, at 748 ("The function of the preference concept is to avoid prebankruptcy transfers that distort the bankruptcy policy of distribution."); McCoid, *supra* note 35, at 260 ("Equal treatment of creditors is the oldest and most frequently advanced goal of preference law."); Weisberg, *supra* note 35, 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.").

law that undermine this notion of equality.[71] I have previously argued that preference law as an equalizing mechanism is unnecessarily hampered by exceptions that purport to deter undesirable behavior.[72] Nonetheless, other scholars view deterrence as the primary justification for preference law, or at least emphasize the need for preference law to fulfill its role of deterrence, even if it undercuts other goals.[73] To these scholars, preference law has

> [a] necessary and important role . . . in controlling express opt-out behavior by in-the-know creditors . . . who . . . shore up their positions in derogation of the bankruptcy priority scheme by obtaining or perfecting liens, seizing assets, pressuring the debtor for transfers and payments, or otherwise accepting property from the debtor in respect of claims on the eve of bankruptcy.[74]

These scholars see the exceptions to preference liability, particularly the ordinary course of business defense, as limiting the sting of preference liability to those who collect as a response to the perceived insolvency or pending failure of the debtor.[75]

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71. *See* Broome, *supra* note 42, at 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.") (quoting H. REP. NO. 95-595, at 177-78); Ponoroff & Ashby, *supra* note 42, at 19 ("[T]he lack of improper ulterior motive in inducing or accepting payment from a debtor is no longer a sufficient basis for allowing one creditor to achieve a better result than its similarly placed counterparts."); Charles Jordan Tabb, *Rethinking Preferences*, 43 S.C. L. REV. 981, 990 (1992) [hereinafter *Rethinking Preferences*] (submitting that it should be irrelevant whether preferred creditors knowingly obtained payment from a debtor likely to seek bankruptcy relief or not).

72. *See* Gotberg, *supra* note 2, at 59.

73. *See, e.g.*, Daniel J. Bussel, *The Problem with Preferences*, 100 IOWA L. REV. BULL. 11, 15 (2014) ("[P]reference law has always emphasized controlling [knowing attempts to recover ahead of other creditors] over forced disgorgement of innocently received preferences.").

74. *Id.* at 14-15.

75. *See, e.g.*, Afilalo, *supra* note 44, at 635 (arguing that the ordinary course of business exception extends protection to those who are not racing to the courthouse); Bussel, *supra* note 73 ("The defenses to preference law are designed largely to protect innocent receipt of preferences; they commonly do not apply to parties that can be shown to have deliberately subverted ratable distribution on the eve of bankruptcy."). At least one author has argued for greater protection for creditors and an expansion of defenses on these grounds. *See* Michael J. Herbert, *The Trustee Versus the Trade Creditor: A Critique of Section 547(c)(1), (2) & (4) of the Bankruptcy Code*, 17 U. RICH. L. REV. 667, 691-92 (1983) (arguing that trade creditors who recognize a buyer's drift into bankruptcy but nonetheless continue to do business with the debtor deserve significant protection from preference liability).

Although the primary purpose of this Article is not to challenge the merit of congressional intent behind preference law as a deterrence, a few points are worth raising in response to this goal, if only in passing. First, the assumption that debtors are better off struggling to repay debt outside bankruptcy, rather than inside bankruptcy, is not clearly supported in practice. Debtors may be better off in the long run and may more successfully reorganize when they are pushed to file earlier (perhaps in response to collection efforts) rather than later. Put another way, a marginally insolvent company may be significantly easier to reorganize than a significantly insolvent company. Second, Congress is not altogether clear as to which "courthouse" it wishes to deter creditors from visiting. The Bankruptcy Code does permit creditors to file an involuntary petition to invoke bankruptcy proceedings against an unwilling debtor.[76] Creditors are encouraged by virtue of preference law to use a bankruptcy filing (or threat of filing) to force the clawback of payments the debtor may have made to other creditors.[77] Finally, attempting to deter creditor collection for a ninety-day period ignores the possible detrimental effect that prolonged non-payment will have on those creditors, who presumably have their own bills to pay in the meantime. Arguably, it would be better for all involved if resolution of outstanding debts were accomplished on a faster timeframe.

## IV. THE GAP BETWEEN INTENDED AND ACTUAL TARGETS

Assuming, *arguendo*, that the goal of deterring opt-out behavior from creditors who seek to "scramble . . . for advantage" is a worthy one,[78] and that creditors are rational actors who take preference law into account in making decisions to collect on debts,[79] preference law is nevertheless fundamentally flawed as a

76. *See* 11 U.S.C. § 303 (2012).

77. *See* Interview with Paul Hoffmann (Feb. 9, 2018) ("When I represent creditors dealing with debtors in financial distress, I routinely advise them to look for evidence of preferential transfers because that is a sign that they should seriously consider filing an involuntary case.") (notes in possession of author).

78. H.R. DOC. NO. 93-137, at 202 (1973).

79. This is yet another questionable assumption, particularly for creditors unfamiliar with preference law. *See supra* note 5 and accompanying text; E-mail from Paul Schrader, Fullerton Law, to author (Mar. 26, 2018, 5:14 PM CST) ("[T]he idea of refusing payment when

deterrent. The most obvious flaw is that preference liability utterly fails to discriminate between creditors who are deliberately attempting to "opt-out" of the bankruptcy distribution and creditors who are totally ignorant of the debtor's financial stress. One of the reasons creditors prove to be consistently resentful of preference liability is that they cannot comprehend how they are considered "preferred" when they have no close association with the debtor and had no knowledge of the debtor's planned bankruptcy filing. Such creditors frequently have significant unsecured debt outstanding, despite the transfer, that will be discharged in the bankruptcy. Preference law fails to exclusively target bad actors; instead it affects any transferees who happen to fall within the ninety-day window.[80]

### *A. Bad Actors*

No doubt in large part because of the competing rationales for preference law, the targets of preference liability have shifted over the years. Early English preference law, as interpreted by Lord Mansfield in *Alderson v. Temple*,[81] suggested that only fraudulent collection efforts, or those undertaken "manifestly to defeat the law" are "bad."[82] In other words, voluntary efforts by the debtor to favor certain creditors over others were the target, and transfers made to creditors that demanded, sued, or threatened the debtor to induce repayment they were legally entitled to were not subject to preference law.[83] Early preference law in the United States under the 1841 Act also targeted transfers made by the debtor "in contemplation of bankruptcy" and "for the purpose of giving any

a debtor wants to pay you is so detached from standard commercial practice that it just cannot be conceived of as 'rational' by even the best-informed creditor.") (on file with author).

80. This is deliberate in light of the overarching goal of equality. Scholars have argued against attempts to distinguish between creditors based on their intentions in accepting a preference, as the intention ultimately has no impact on the ultimate reduction of the estate. *See Rethinking Preferences, supra* note 71, at 992 ("More than anything else, preference theory needs to shake off this antiquated morality notion and embrace instead the equality principle.").

81. Alderson v. Temple, 96 Eng. Rep. 384 (K.B. 1768).

82. *Id.* at 385.

83. *Id.*; 8 WILLIAM SEARLE HOLDSWORTH, A HISTORY OF ENGLISH LAW, 237 (2d ed. 1937).

creditor . . . any preference or priority over the general creditors,"[84] with liability hinging on the debtor's intent, rather than the creditors'. The law changed in 1867 to include in its evaluation whether or not a recipient creditor had reasonable cause to believe the debtor was insolvent at the time of the transfer.[85] By the 1898 Act, the American law had changed focus to look exclusively at creditor intent, limiting liability to those cases in which "the person receiving [the transfer] . . . shall have had reasonable cause to believe that it was intended thereby to give a preference."[86] Proven ignorance of the debtor's financial situation was a defense to preference liability.

The Bankruptcy Code, passed in 1978, ultimately eliminated any requirement that the creditor be aware of a debtor's insolvency or that the debtor intend to favor a particular creditor, establishing preference as a matter of strict liability.[87] Many scholars view this legislative move as evidence that preference law was not intended and should not be used to distinguish between "innocent" and "culpable" creditors,[88] and accordingly criticize mechanisms like the ordinary course exception that do make distinctions between creditors.[89] Others continue to advocate for exceptions to preference liability on the justification that they protect creditors who lack the intent or motivation to undermine the bankruptcy

84. Bankruptcy Act of 1841, ch. 9, § 2, 5 Stat. 440 (repealed 1843). The law further provided that one who granted a preference to a creditor would be denied discharge.

85. *See* 14 Stat. 517, ch. 176, § 35 (1867) *repealed by* 20 Stat. 99 (1878).

86. Bankruptcy Act of 1898, ch. 541, § 60(b), 30 Stat. 544 (repealed 1978); *see also* Raymond T. Nimmer, *Security Interests in Bankruptcy: An Overview of Section 547 of the Code*, 17 HOUS. L. REV. 289, 291 (1980) (discussing at length the requirements for preference liability under the Bankruptcy Act).

87. *See* discussion *supra* note 33; *see also* REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, H.R. DOC. NO. 93-137, pt. 1, at 214–15 (1973). "That [intent] requirement, more than any other, has rendered ineffective the preference section of the present Act." *Id.* at 204.

88. *Rethinking Preferences*, *supra* note 71, at 992 ("More than anything else, preference theory needs to shake off this antiquated morality notion and embrace instead the equality principle.").

89. *See* Countryman, *supra* note 37, at 775–76 (1985) (arguing that the ordinary course exception should be repealed as it conflicts with preference policy); *Rethinking Preferences*, *supra* note 71, at 1034 (proposing to repeal the ordinary course exception to increase the certainty in and simplicity of preference lawsuits).

distribution.[90] Congress toyed with the idea of amending the Bankruptcy Code shortly after its adoption to reinsert a "reasonable cause to believe" requirement as an element of a preferential transfer, presumably to protect creditors who were not aware of the debtor's financial issues, but ultimately failed to do so.[91]

Scholars who do view contemporary preference law as a means to deter bad creditor behavior disagree on precisely the type of behavior that should be subject to deterrence. Accordingly, it is difficult to parse out who are the bad actors—the individuals who *should* be liable under preference law in order to deter their bad acts. Instead, much of the discussion surrounding how preference law and its exceptions should be drafted has stemmed from opinions regarding who should *not* be subject to preference liability.

Lawrence Ponoroff and other prominent scholars have argued that the ordinary course exception arose in large part to protect "small, local suppliers of routine, open account credit."[92] In other words, preference law was not intended to affect "recurring, customary credit transactions that would have taken place in the ordinary course of the debtor's and creditor's businesses regardless of whether the prospect of a bankruptcy filing was looming or not."[93] The goal was simply to prevent unusual or extreme collection efforts.[94] There is some suggestion that the ordinary course exception was passed in particular to protect trade creditors, defined loosely as creditors who do not function as lenders, but rather extend credit by permitting delayed payment for goods and services.[95] For example, members of Congress proposed exceptions

90. *See, e.g.*, Afilalo, *supra* note 44, at 635; *see also* Charles Jordan Tabb, *Panglossian Preference Paradigm?* 5 AM. BANKR. INST. L. REV. 407, 412 (1997) ("The idea that only abnormal prebankruptcy grabs should be avoidable, entrenched for several hundred years, apparently is here to stay.").

91. *See* Broome, *supra* note 42, at 107.

92. Ponoroff & Ashby, *supra* note 42, at 16; *see also* Countryman, *supra* note 37, at 769 ("If there was an intent to limit the [ordinary course] exception also to 'trade debt,' the draftsmen must have despaired of attempting to define that frequently used but intensely undefined term, and invoked the forty-five day limitation in recognition that most of the trade debt at which they were aiming was short term.").

93. Ponoroff & Ashby, *supra* note 42, at 18.

94. *See* Nimmer, *supra* note 86, at 291.

95. *See, e.g.*, Broome, *supra* note 42, at 121.

to preference law for debts associated with delivery of goods in the three months prior to bankruptcy, and debts for personal services.[96] However, congressional revisions to the law ultimately led to the Supreme Court's ruling that long-term debt issued by a lender would satisfy the ordinary course exception,[97] leaving the exception more uncertain and less targeted towards its original intended beneficiaries.[98]

Some scholars have argued that the size of the transfer is what matters and that small creditors or small transfers should be exempt from the law, but this position is not without its critics. Daniel Bussel has argued that pursuit of small preference actions is akin to reorganizing deck chairs on the Titanic, and pushed for a higher cap on preference liability actions.[99] On the other hand, Charles Tabb has voiced opposition to such a move on the argument that a statutory cap for liability not only undermines the equality goal of preference but also "might well encourage aggressive pre-petition debt collection efforts for amounts of a few thousand dollars, but slightly below [the cap]."[100]

In light of Congress' expressed intention to discourage a "race to the courthouse" and the premature dismantling of the debtor, it is my view that the true "bad actors" Congress sought to deter must be those with actual power to dismantle the debtor.[101] The reference to the courthouse suggests that those Congress had in mind were judgment creditors—those who had successfully brought suit

96. *See* REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, H.R. DOC. NO. 93-137, pt. 2, at 168 (1973) (proposed exceptions for "(A) a debt for personal services, (B) a debt for utilities incurred within three months of the petition, [or] (C) a debt for inventory paid for within three months of the delivery of the goods in the ordinary course of the debtor's business.").

97. *See* Union Bank v. Wolas, 502 U.S. 151, 162 (1991).

98. *See* Tabb, *supra* note 43, at 441 (suggesting that the ABI Report demonstrates that the ordinary course exception is not working well because "no one knows what it means, . . . the application of the defense is inconsistent[, and] . . . many respondents do not believe that the defense affords sufficiently broad protection").

99. Bussel, *supra* note 73, at 12.

100. *Brave New Word*, *supra* note 43, at 434.

101. A broader reading of congressional intent would be that Congress intended to discourage any attempt, however routine or ineffectual, to collect, although most discussion by courts interpreting the law seems to imply the need for collection to have a significant or disruptive effect on the debtor. *See, e.g.*, *In re* Forman Enters., Inc., 293 B.R. 848, 855 (Bankr. W.D. Penn. 2003); *In re* M & L Bus. Mach. Co., 184 B.R. 136, 140 (Bankr. D. Colo. 1995); *In re* Bourgeois, 58 B.R. 657, 660 (Bankr. W.D. La. 1986); *In re* Air Fla. Sys. Inc., 50 B.R. 653, 656 (Bankr. S.D. Fla. 1985).

against the debtor—and who would be in a position to dismantle the debtor by executing liens on the debtor's property pursuant to their judgments. With the debtor's property in the sheriff's hands, it would be impossible for the debtor to conduct business. In order to continue, the debtor would be forced to file for bankruptcy, if only to impose the automatic stay and enforce return of the estate property to the debtor. In contrast, unsecured creditors who have not yet obtained a judgment against a debtor have relatively little leverage or ability to impact the debtor's business. They cannot exercise self-help to insist on repayment and are limited to collection tactics such as withholding future services and making demanding phone calls. Nonetheless, it is often these unsecured creditors—commonly trade creditors—who have extended credit in the form of delayed payment on goods and services, who are targeted by preference liability, despite the general perception that such creditors were intended to be protected from liability.

### *B. True Targets*

It is not uncommon for trade creditors to find themselves subject to preference liability. Despite this, and perhaps because of the relative infrequency of bankruptcy itself, many trade creditors are astonished to hear that they are being sued, particularly when they are still owed money by the debtor. Among this group, the less sophisticated and less important creditors tend to suffer the most from preference enforcement.[102] Creditors who are familiar with the law are more likely to take advantage of its defenses, and creditors who are viewed as vital to the debtor's survival are typically not targeted, at least not by a DIP in Chapter 11.[103]

Per the statute, a trustee may bring a preference action without consideration of whether potential defenses exist.[104] Still, before

102. *See* discussion *infra* note 113 and accompanying text.

103. *See* Brook E. Gotberg, *Relational Preference in Chapter 11 Proceedings*, 71 OKLA. L. REV. (forthcoming).

104. The International Housewares Association (IHA), a major trade organization, proposed in 2014 that § 547 be amended to shift the burden of proof to the trustee, rather than creditors, that a payment is not a preference. *See, e.g., Examining Sect. 547 and Its Effect on Trade Creditors – Episode 153*, AM. BANKR. INST. (Nov. 6, 2014), https://www.abi.org/podcasts/examining-sect-547-and-its-effect-on-trade-creditors-episode-153 [hereinafter

committing to the cost of filing a formal complaint, trustees often engage in letter-writing campaigns to all creditors who received transfers from the debtor in the ninety days before the bankruptcy filing, citing the preference statute and demanding a return of the funds transferred.[105] Well-advised creditors typically respond with evidence of possible defenses, which often leads to settlement of those claims with the trustee for substantially less than what has been demanded.[106] Less sophisticated creditors may not realize that defenses are available and when faced with the prospect of liability may simply repay the entire amount.[107] Although the exceptions to preference law were intended to shield ordinary transactions from liability, less sophisticated creditors may be unaware of these defenses and may be unable or unwilling to hire counsel to defend against a preference in a situation where they are already losing money.

In Chapter 11, unsecured creditors who qualify for the coveted title of "critical vendor" are not subject to preference liability. Although the Bankruptcy Code does not acknowledge the term or the concept of a critical vendor, courts across the country have granted debtor motions to pay certain unsecured creditors their pre-bankruptcy claims prior to the confirmation of a plan of reorganization.[108] In support of a critical vendor motion, the debtor argues that the ongoing cooperation of a specific creditor is essential to the debtor's reorganization and cannot be obtained

*Examining Sect. 547*] (conversation between ABI Residence Scholar Lois Lupica and Dale Matschullat, Chairman of IHA, and Bruce Kaminstein, CEO of Casabella Holdings, LLC).

105. In some cases, the trustee may not have time to engage in such a letter writing campaign, however, and may find it necessary to file the action without preliminary discussion or negotiation. A trustee faces a statute of limitations in bringing the preference action and must sometimes file complaints without engaging in significant background research simply in order to preserve the cause of action. *See* 11 U.S.C. § 546(a) (2006) (imposing two-year statute of limitations on avoidance actions under § 547); COMMERCIAL FIN. ASS'N, FIRST REPORT OF THE COMMERCIAL FINANCE ASSOCIATION TO THE ABI COMMISSION TO STUDY THE REFORM OF CHAPTER 11 (Nov. 15, 2012) (complaining that trustees need not weigh the likely value of their claims, and encouraging imposing a pleading burden on trustees that there are no relevant defenses).

106. *See* Telephone Interview with DA (Sept. 8, 2017) ("Not because you're afraid to take it to trial, that's not the issue. The issue is, . . . what's the cost for that litigation versus what's the exposure and what you need to pay to be done with this.").

107. *See* ABI PREFERENCE SURVEY, *supra* note 53; discussion *infra* note 175.

108. *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).

without repayment. Courts justify the special treatment of such creditors under § 105(a) of the Bankruptcy Code and pre-Code practices affording equitable priority to certain unsecured creditors.[109] Although not every court recognizes or upholds critical vendor motions,[110] creditors who qualify for critical vendor status are typically immune from preference liability.[111] Likewise, courts have held that prepetition payments made under an executory contract assumed by the debtor cannot be recovered as preferences.[112] A DIP may also simply elect not to pursue a claim against a particular creditor, in order to avoid souring the relationship or engaging in what is likely to be protracted litigation.[113] Other creditors may also escape preference liability on the basis of the size of their claim and their location vis-à-vis the

109. *See* 11 U.S.C. § 105(a) (2012); Resnick, *supra* note 108, at 186. Although generally perceived to grant bankruptcy judges discretion to ensure that reorganizations will not be unnecessarily stilted by inflexible rules, use of § 105(a) is subject to heavy criticism when used in ways perceived to be contrary to the rest of the Code. *See, e.g.*, Law v. Siegel, 134 S. Ct. 1188, 1194 (2014) (requiring that § 105(a) yield to prohibitions found elsewhere in the Code).

110. *See, e.g.*, *In re* Kmart Corp., 359 F.3d 866 (7th Cir. 2004); Chiasson v. J. Louis Matherne & Assocs. (*In re* Oxford Mgmt., Inc.), 4 F.3d 1329 (5th Cir. 1993); B&W Enters., Inc. v. Goodman Oil Co. (*In re* B&W Enters., Inc.), 713 F.2d 534 (9th Cir. 1983).

111. *See* Andrew J. Currie & Sean McCann, *Hold on to Those Payments, Critical Vendors:* Capital Factors v. Kmart, AM. BANKR. INST. J., June 2003, at 33, 35 ("[V]endors should use an agreement to provide post-petition goods and services on customary terms as an opportunity to extract a promise from the debtor that it will not seek to assert preference claims (or § 549 claims) against the vendor."); Telephone Interview with CA (May 30, 2017) (noting that debtors may defend the decision not to pursue a preference on a creditor's status as critical vendor).

112. *See* Newpage Corp. v. Avoca Bement Corp. (*In re* Newpage Corp.), 517 B.R. 508, 514 (Bankr. D. Del. 2014); MPF Holding U.S. L.L.C. v. Mustang Eng'g Ltd. (*In re* MPF Holding U.S. L.L.C.), 495 B.R. 303 (Bankr. S.D. Tex. 2013).

113. *See* 11 U.S.C. § 547(b) (2012) (noting that a trustee "may" avoid a preferential transfer); *see also* discussion *infra* note 134 and accompanying text; Telephone Interview with CA (May 25, 2017) (noting that some debtors may decide not to bring preference actions for reputational reasons); Telephone Interview with DA (June 23, 2017) ("I mean, if it's a smaller dollar amount and the liability is questionable, then maybe you don't pursue those claims. I mean, this is kind of a cost-benefit analysis. If it's a million dollars, then you're going to look at it much more seriously, but ten thousand dollars, you can easily [eat] that with the legal fees; just to try to get it."); Telephone Interview with DA (May 25, 2017) (weighing considerations of collectability, noting that most preference actions are waived in a true reorganization).

debtor, usually points that are irrelevant to the creditor's influence over a bankruptcy filing.[114]

The less sophisticated, less informed, and less important creditors that do find themselves subject to preference liability usually lack any control over a debtor's bankruptcy filing, including the power to effectively "push" a debtor into bankruptcy. Frequently, such creditors have taken no affirmative action against the debtor at all but have merely accepted payment on account of their outstanding debts at the wrong time, and in the wrong way—that is, outside one of the delineated exceptions to preference liability. Preference law punishes rather than deters such creditors, as they typically are unaware that liability is a possibility when they collect.[115] Further, the behavior of such creditors punished by preference law is frequently the passive acceptance of payment rather than any affirmative action, including a "race to the courthouse." On the other hand, by excluding more savvy creditors with power to impact the debtor, by virtue of exceptions and discretion in bringing actions, the law allows some creditors who may have deliberately improved their position prior to bankruptcy at the expense of other creditors to escape liability. In sum, the law fundamentally fails to target the behavior it wishes to deter by being both under- and over-inclusive of transfers.

## V. PREFERENCE MODEL OF DETERRENCE

As explained in this Part, the law fails to deter even individuals who are familiar with its parameters because the likelihood of liability and the penalty associated with preference liability together do not justify the alteration of behavior pursuant to a rational cost-benefit analysis. As discussed in Part II, a model can gauge the effectiveness of penalties in deterring any inappropriate

114. Pursuant to 28 U.S.C.A. § 1409 (West 2016), the trustee is required to bring actions for amounts less than $12,850 within the district court in which the defendant resides. This alteration likely encouraged bankruptcy trustees to be more selective about cases they choose to bring in distant venues, as it will cost the estate more to prosecute cases abroad. *See Brave New Word*, *supra* note 43.

115. *Rethinking Preferences*, *supra* note 71 ("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."); *see also* Nimmer, *supra* note 86, at 292.

behavior. The model for preference law, unfortunately, is not easy to apply. It must incorporate uncertainty regarding enforcement, due to factors over which the creditor has virtually no control, and uncertainty regarding the associated punishment, due to a mix of factors only some of which the creditor can control. This model, like Becker's, does not explicitly acknowledge the weaknesses of rational choice theory, including other factors that influence individual behavior. But it is unnecessary to challenge the rational choice assumption; even under that assumption, it is evident that preference law is an ineffective deterrent. As I demonstrate in this Part, empirical evidence further supports the conclusion that most creditors do not change their behavior in response to preference law, at least not in ways intended by the statute. The primary factors within the preference model are, as in Becker's model, the likelihood of enforcement and the severity of the punishment associated with preference liability.

### *A. Likelihood of Punishment*

#### *1. Requirement of bankruptcy*

Uncertainty regarding enforcement arises in preference law because preferential transfers are only subject to punishment if the debtor—or in rare cases, another creditor[116]—elects to invoke the jurisdiction of the bankruptcy and federal bankruptcy laws by filing a bankruptcy petition. The likelihood of bankruptcy is uncertain even in cases where the debtor is clearly insolvent, as the debtor may decide to attempt other methods of reorganization or simply to go out of business.[117] Bankruptcy may be the most visible and even the most common method for companies to attempt to turn around their financial affairs, but it is by no means the only option. An effort to increase the use of state insolvency proceedings

116. Creditors may file involuntary cases against a debtor. *See* 11 U.S.C. § 303 (2012).

117. *See* Edward R. Morrison, *Bargaining Around Bankruptcy: Small Business Workouts and State Law*, 38 J. LEGAL STUD. 255, 260–61 (2009) (reporting that in 1990, business bankruptcy filings amounted to only about twelve percent of all business failures). It is worth noting that most business failures involve no attempt to reorganize at all. Instead, the company simply ceases to exist as a going concern, and creditors are left to attempt collection efforts under state law or write off losses, as the situation allows. *Id.*

has been observed across recent years,[118] and the majority of states do not recognize a general cause of action for preferential transfers.[119] Accordingly, in most cases there will be no preference liability if a debtor does not file for bankruptcy.

In addition to requiring a bankruptcy filing, preference liability is also limited to situations where the debtor has filed within ninety days of a given transfer. In absolute terms, the likelihood of any given business filing for bankruptcy within a three-month period is very low. Out of an estimated 29 million businesses in the United States,[120] less than 6000 companies file for bankruptcy in a given three-month period.[121] This places the likelihood of a given company filing for bankruptcy at roughly 0.02%. Some bankruptcies may be easier to predict than others, and obviously the likelihood of a bankruptcy filing may be higher if the company is known to be struggling, but even then, bankruptcy is not an inevitability. The ultimate decision of whether and when to file for bankruptcy generally lies with the debtor. More sophisticated creditors may negotiate with debtors to file more than ninety days after a particular transfer has taken place, but most unsecured creditors have little to no influence over the timing of a bankruptcy.[122]

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118. *See, e.g.*, Andrew B. Dawson, *Better than Bankruptcy?*, 69 RUTGERS U. L. REV. 137 (2016).

119. Many states do have preference laws that apply in the context of bank or insurance company insolvency. Such companies may not be debtors under federal bankruptcy law. *See* 11 U.S.C. § 109(b)(2) (2012); David A. Skeel, Jr., *Rethinking the Line Between Corporate Law and Corporate Bankruptcy*, 72 TEX. L. REV. 471, 493, 516–26 (1994) (arguing for shifting authority over corporate bankruptcy back to the states to encourage greater consistency between state and federal insolvency laws). Roughly half of all state preference actions require a showing of preferential intent from the debtor, which is difficult to prove and entirely absent from federal law. *See* Broome, *supra* note 42, at 93–94.

120. *See* OFFICE OF ADVOCACY, U.S. SMALL BUS. ADMIN., FREQUENTLY ASKED QUESTIONS 1 (June 2016), http://www.sba.gov/sites/default/files/advocacy/SB-FAQ-2016_WEB.pdf (estimate is as of 2013).

121. U.S. Courts' statistics report a total of 5669 commercial filings (including farms, fisheries, and wage worker filings identified as "business filings") for the first quarter of 2018, U.S. COURTS, CASELOAD STATISTICS DATA TABLES tbl.F-2 (Mar. 31, 2018), http://www.uscourts.gov/sites/default/files/data_tables/bf_f2.3_0331.2018.pdf; and a total of 23,157 commercial filings in the entire year of 2017, U.S. COURTS, CASELOAD STATISTICS DATA TABLES tbl.F-5A (Dec. 31, 2017), http://www.uscourts.gov/sites/default/files/data_tables/bf_f5a_1231.2017.pdf.

122. Creditors cannot control the risk of a bankruptcy filing by prohibiting a debtor from filing a bankruptcy case or by invoking penalties for filing for bankruptcy. Such attempts are rendered null and void pursuant to bankruptcy law. *See, e.g.*, 11 U.S.C.

*2. Uncertainty of enforcement*

Prior studies of deterrence have concluded that probability of conviction is significantly more impactful to deterrence than the severity of punishment.[123] Preference liability within a bankruptcy case is highly contingent upon a variety of factors, including the chapter of bankruptcy in which the case will proceed, the availability of defenses for vulnerable creditors, the presence and activity of a creditor's committee, and the intended outcome of the company in the reorganization proceedings. The creditor's relationship with and importance to the debtor's business going forward may also play a factor, both for critical vendors and for other creditors not so specified.[124]

Preference actions are significantly more common in Chapter 7 liquidation proceedings and Chapter 11 liquidation cases than in Chapter 11 reorganization proceedings. The most obvious explanation for the discrepancy is that all parties recognize that preference proceedings—effectively lawsuits raised by the debtor against the creditors—may be bad for business and bad for relationships going forward.[125] Accordingly, debtors are typically reluctant to pursue preference actions in reorganization proceedings where ongoing relationships are important. The same reluctance does not exist in liquidation proceedings where there is

§§ 365(e)(1), 541(c)(1)(B) (2012). On the other hand, creditors may offer benefits to a debtor on the condition that the debtor not file for bankruptcy, and otherwise work with the debtor in an attempt to avoid bankruptcy proceedings. Such efforts to negotiate an agreement are always colored by the reality that, if the benefits are inadequate or outside pressures to file too strong, the debtor can always revert to a bankruptcy petition for relief.

123. *See* Becker, *supra* note 17, at 176 ("[A] common generalization by persons with judicial experience is that a change in the probability [of punishment] has a greater effect on the number of offenses than a change in the punishment."); Travis C. Pratt et al., *The Empirical Status of Deterrence Theory: A Meta-Analysis*, *in* TAKING STOCK: THE STATUS OF CRIMINOLOGICAL THEORY 367 (Francis T. Cullen et al. eds., Transaction Publishers 2006) (observing that crime and deviance are more accurately predicted by peer effects or self-control than by deterrence variables but that, of all deterrence factors, certainty of punishment was the most influential in affecting behavior).

124. *See* discussion *supra* note 113.

125. *See, e.g.*, Telephone Interview with CA (May 25, 2017) (observing that debtors may choose not to pursue a preference because the reputational cost may make doing so not worth the effort); Telephone Interview with DA (May 19, 2017) ("[P]reference actions don't really engender a lot of good will. . . . I mean it's only a good idea if you really need the money.").

no chance for ongoing relationships;[126] Chapter 7 trustees have a reputation for being more aggressive and active in pursuing preference actions than the average DIP.[127]

In either chapter, trustees and DIPs are less inclined to bring preference actions in situations where the creditor may have a strong defense. This is consistent with regular notions of litigation strategy—the goal for both trustees and DIPs is to maximize the recovery for the debtor's estate while minimizing the costs associated with that recovery. Accordingly, most preference proceedings begin with a letter-writing campaign in which the debtor's representative will contact those who have received payments from the debtor in the previous ninety days with a demand to return such payments.[128] Response to this letter-writing campaign will determine which complaints are actually filed. Creditors may respond to letters with the offer of a nuisance settlement, a blanket denial of any liability, or a demonstration of possible defenses. These responses, especially the demonstration of a strong defense, may prompt a trustee or DIP to abandon the preference claim altogether.[129]

126. Often, when preference actions are brought in a Chapter 11 case, it is in the context of a liquidation plan or a liquidating trust, put in place after the sale of the company has been successfully concluded. *See* discussion *infra* note 129

127. *See* Adelphia Commc'ns Corp. v. Bank of Am., N.A. (*In re* Adelphia Commc'ns Corp.), 330 B.R. 364, 373 (Bankr. S.D.N.Y. 2005) ("Debtors sometimes lack the inclination, or the means, to bring actions that should be prosecuted. They sometimes have higher priorities, or are distracted by other things. They sometimes have a practical need to avoid confrontation with entities like their secured lenders, because they need those entities' continuing cooperation—as, for example, in connection with exit financing."); Nancy Haller, Cybergenics II: *Precedent and Policy vs. Plain Meaning*, 56 ME. L. REV. 365, 384–85 (2004) ("A debtor-in-possession . . . may use the trustee provisions to favor certain creditors; may be unwilling to avoid transactions with a supplier or lender with whom it hopes to continue a business relationship after a successful reorganization; or may have developed friendships that make it difficult to choose to pursue actions with severe economic impacts.").

128. *See* Telephone Interview with CA (May 25, 2017); 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."); 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 (May 25, 2017).

129. They may drop the claim both for efficiency reasons—it is likely to cost too much to pursue in light of the likely recovery—and for fear of repercussions if they continue to pursue what looks like a losing case. Courts have ruled that a trustee may be held liable for sanctions under Bankruptcy Rule 9011 for bringing a preference action without adequately investigating the availability of an affirmative defense. *See In re* Excello Press, Inc., 967 F.2d 1109, 1112 (7th Cir. 1992) (ruling that at times a trustee may have a responsibility to examine

*3. The strategic importance of a creditor*

For cases that proceed in Chapter 11, creditors may be in a position to influence whether and which preference claims are brought. Creditors are typically more involved in Chapter 11 cases than they are in Chapter 7 and have influence over the shape of the case. For example, in Chapter 11, creditors are able to vote in favor or against the debtor's plan of reorganization.[130] The U.S. Trustee may also appoint a creditor's committee, which can employ its own counsel—paid from the estate's administrative funds—to oversee the proceedings and petition the court for action when necessary.[131] A creditor's committee might have different opinions regarding preference actions depending on the circumstances of the case. For example, the committee may be enthusiastic about the recovery of a significant preferential transfer from an insider or a secured creditor, but less enthusiastic about recovering a plethora of smaller preferential transfers from among its own membership—typically unsecured trade creditors. It is common for the committee to negotiate a provision in the plan of reorganization abandoning all preference claims, turning over all preference claims to the committee or to a liquidating trust, or otherwise adjusting how such claims will, or will not, be pursued.[132] Individual creditors who have influence over the creditor's committee are accordingly in a better place than others to influence whether, and against whom, preference actions are brought.

Chapter 11 debtors may also be more selective than Chapter 7 trustees regarding which preference actions, if any, they elect to

whether any obvious affirmative defenses bar the case); Thomas D. Goldberg, *Curbing Abusive Preference Actions: Rethinking Claims on Behalf of Administratively Insolvent Estates*, AM. BANKR. INST. J., May 2004, at *14, *17 (citing ethical reasons why a practitioner should not commence a preference action where there may be meritorious affirmative defenses).

130. *See* 11 U.S.C. § 1126 (2012).

131. *See id.* §§ 1102–1103.

132. *See, e.g.*, Moecker v. Johnson (*In re* Transit Group, Inc.), 332 B.R. 45, 53 (Bankr. M.D. Fla. 2005) (observing that the plan of reorganization assigned the debtor's rights to prosecute avoidance actions to the creditors' committee); *see also* Telephone Interview with CA (Aug. 8, 2017) (noting common practice of putting preference actions into a trust for the benefit of creditors); Telephone Interview with DA (June 19, 2017) (stating that these days preference actions are all brought by a liquidating trust); Telephone Interview with PC-B (Sept. 7, 2017) ("Whoever the creditors were, hired [a] collection company to shake down all the people [who] had been paid for services rendered within the ninety-day window.").

pursue.[133] Attorneys interviewed for this project were divided on whether the Bankruptcy Code sanctions this sort of selectivity. Most argued that the permissive language of the Code, indicating that the trustee or DIP "*may* avoid" preferential transfers, is deliberate, and permits a debtor to pursue or ignore preferences in keeping with its best interest in the long term.[134] Others noted the duty of the debtor to maximize recovery for all creditors, and concluded the debtor is bound to pursue all preferences regardless of whether doing so may be bad for the debtor's future business dealings.[135] All agreed that preference actions are typically a low priority and tend to be pursued, if at all, after more pressing issues of estate administration have been settled. In many cases, preference actions are only brought after the plan has already been approved so as to minimize potential negative ramifications for the vote on the plan.[136]

When the plan of reorganization involves selling the debtor as a going concern, the purchasing buyer may negotiate for any preference claims to be sold as part of the deal. However, the buyer will

133. The same permissive language would apply to Chapter 7 trustees who "may" avoid which preferences they prefer. However, Chapter 7 trustees are less likely than debtors to discriminate between creditors and more likely to examine potential preference actions solely on their merits, rather than evaluating the strategic value of a given creditor. This is true for the simple reason that a Chapter 7 trustee is unconcerned with a debtor's ability to continue as a going concern and the need to do business with creditors going forward. Once the case is in Chapter 7, the decision to liquidate the business has already been made. Further, Chapter 7 trustees are compensated as a percentage of the dollar amount they bring into the estate and, accordingly, are personally incentivized to maximize the dollar return regardless of where the dollar comes from. *See* 11 U.S.C. § 326 (2012).

134. *Id.* § 547 (emphasis added); *see also, e.g.*, Telephone Interview with DA (June 20, 2017) ("I think it is a 'may.' I don't think you are required to bring [preference actions] and I think the Bankruptcy Code allows for that decision-making process."); Telephone Interview with DA (May 19, 2017) ("[I]t's a permissive section you know; it says that they may bring them. So, I think that's there for a real reason.").

135. *See* 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."); 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.").

136. *See* 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 a 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."); 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."); discussion *supra* note 126.

generally decline to pursue such preferences, determining that their negative effects on business relationships will outweigh whatever income they may generate.[137] This may be controversial for the creditor's committee, particularly if the avoidance actions are some of the only remaining assets available to unsecured creditors.[138] Although trade creditors are generally very much in favor of restricting preference liability,[139] there may be instances in which the recovery of a preference is their only recovery in bankruptcy.

Ultimately, the enforcement of any given preference claim is highly uncertain and subject to a wide variety of factors, especially in Chapter 11 reorganization cases. The probability of preference liability for a creditor is negatively associated with the strategic importance of the creditor to the debtor's business and stated defenses to liability. Accordingly, the probability of a preference action being raised decreases with the sophistication of a creditor, leading more sophisticated creditors to be less deterred from pre-bankruptcy opt-out behavior.[140]

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137. *See, e.g.*, Telephone Interview with CA (July 26, 2017) ("[W]e have seen in the sale of asset cases where buyers through their asset purchase agreements and then assuming 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 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 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.").

138. For obvious reasons, the sale of a company tends to be for an amount sufficient to satisfy all secured creditors but not necessarily sufficient to satisfy the claims of unsecured creditors. When avoidance actions are granted to creditors' committees instead, they may exercise discretion in whom the actions are brought against. *See* Telephone Interview with CA (June 21, 2017) (noting that committees prefer to bring preference actions against corporate insiders rather than one of their own trade creditors).

139. *See Brave New World*, *supra* note 43, at 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."); *see also Examining Sect. 547*, *supra* note 104.

140. The probability of a successful preference action, $p$, is a function of the probability of a bankruptcy filing within ninety days, $p_b$; the strength of the creditor, including possible defenses and negotiating power, $p_s$; and the amount of discretion exercised by the debtor in bringing preference actions, itself informed by chapter choice, $p_d$. The amount a creditor expends on defense costs, $c$, may also influence the probability of a preference action by

### *B. Expected Liability*

Expected liability associated with preference actions is consistently lower than the expected benefit across all creditor types. The penalty associated with accepting a preferential transfer is limited to the avoidance of that transfer—in layman's terms, the creditor must give back whatever it received from the debtor in exchange for a claim against the debtor's estate. Assuming the creditor does not expend any additional, unrecoverable costs to collect or defend a preference, the worst-case scenario is a wash. From the creditor's perspective, then, there are no actual risks associated with recovery during the preference period. As noted by Tabb:

> An economically rational creditor usually will decide to take a preference. The only sanction of the bankruptcy preference law is that the preferred creditor has to return the money paid, thereby returning to the status that it had before receipt of the preferential transfer. . . . [T]he only potentially lost costs are those associated with receiving the preference in the first place—for example, sheriff's fees and attorneys [sic] fees—and with defending a preference lawsuit, if the creditor chooses to do so.[141]

John McCoid has also observed that, due to the often-significant delay between receipt of a transfer and its recovery by the trustee, creditors may be better off even if they are required to return the full dollar amount of what they collected, due to the time value of money.[142] And the penalty demanded by the trustee or the DIP is usually far less than the full amount of the preference, for the simple reason that the debtor would have to expend funds, time, and attention to obtain a judgment for the full amount of the preference recovery. Each of these three resources is at a premium

strengthening the bargaining power or possible defenses of the creditor, represented by $p_s$. Accordingly, $p = p\,(p_b, p_s, p_d)$.

141. *Rethinking Preferences*, *supra* note 71, at 991 (footnote omitted).

142. McCoid, *supra* note 35, at 264; *see also* E-mail from Paul Schrader, *supra* note 79 (suggesting that the vast majority of creditors would prefer to have money now that they will need to repay over the possibility of a payment at the end of the bankruptcy case). It is worth noting that under English law, unlawful preferences may give rise to a claim of interest against the recipient, although there is some lack of clarity on when the interest should begin to accrue. *See* Adrian Walters, *Preferences*, in VULNERABLE TRANSACTIONS IN CORPORATE INSOLVENCY 123 (John Armour & Howard Bennett eds., 2003).

in any bankruptcy case, whether in Chapter 7 or 11, opening the door to settlement between the parties even in cases of clear liability. One survey of practitioners estimated that the percentage of the claim settled for was, on average, 58.5%, with wide variation.[143]

Much of the variation can be explained by the availability or absence of relevant defenses. Creditors who can predict a bankruptcy filing may adjust their behavior to better align with these defenses in the days leading up to a debtor's bankruptcy, which can both weaken a debtor's incentives to bring a preference action and strengthen a creditor's ability to defend against it.[144] Even creditors who have failed to make adjustments in advance of a bankruptcy filing may, upon advice of counsel, make persuasive arguments that would encourage settlement rather than litigation of issues like the ordinary course exception. Between the advantages of advance planning and strong counsel, the creditors who pay the least in settlement, and are therefore the least deterred, are typically those with access to a debtor's financials who have the ability to structure payments from the debtor in the days before bankruptcy and the resources to hire representation in the subsequent bankruptcy case. To the extent that preference is intended to deter "in-the-know" creditors from altering their

143. ABI PREFERENCE SURVEY, *supra* note 53; *see also* E-mail from Paul Schrader, *supra* note 79 (on file with author) ("[T]he take of trustees and counsel from preference recoveries is often in the 20%–40% range."); 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% or less I suppose, it was rare that it was more than 50%."); Telephone Interview with CA (July 26, 2017) ("[A]s a rule of thumb, [the settlement] should be less than 10%."); Telephone Interview with CA (June 6, 2017) ("In the practical scheme of things they'll take 50 cents on the dollar back, 60 cents."); Telephone Interview with CA (May 18, 2017) (reference to choking a $25,000 claim to $10,000); Telephone Interview with DA (Sept. 8, 2017) (pointing out that settlement payments of up to 75% are made on transfers with no defense, and up to 25% on transfers for which there is a good defense); Telephone Interview with DA (Aug. 31, 2017) (stating that settlement amount ranges from 25 to 90% of the claimed amount); Telephone Interview with DA (July 17, 2017) (stating that preference claims are settled for 20% or less of the face value); Telephone Interview with DA (July 14, 2017) (stating that settlements are 10 to 20% of what is owed); Telephone Interview with DA (June 6, 2017) ("They always settle and they always settle for 40 to 60 cents [on the dollar].").

144. McCoid, *supra* note 35, at 266 (noting that preference law operates to favor creditors with more inside information regarding the debtor's financial situation over those who are less aware).

behavior in the days leading up to bankruptcy, it fails most where it is most needed.[145]

### *C. Preference Deterrence Model*

As explained above, the function for deterrence in preference law is different than it is in the context of criminal law. At its core, however, the two analyses are similar. It might be stated that

$$R_i = R_i\,(p_i,\, l_i,\, c_i),$$

where $R$ is a creditor's expected recovery of past-due debt from the debtor following collection efforts, $p$ is the probability of a preference action being successfully maintained against the creditor, $l$ is the liability of the creditor, and $c$ are associated costs, such as the fees of an attorney or creditor manager who oversees the collection account and negotiates with the debtor and the debtor's estate. Expressed as a utility model, we might say that

$$R = (1\text{–}p)\; r + p\; (r - (l + d)),$$

where $R$ is a creditor's total expected recovery when $p$ is the probability of a successful preference action, $r$ is the amount transferred from debtor to the creditor during the preference period, $l$ is the amount repaid to the debtor's estate pursuant to the settlement agreement or judgment, and $d$ represents costs associated with defending the preference action. In plain language, a creditor's expected recovery is higher when $p$, $l$, and $d$, are lower, that is, when preference actions are less likely, and preference awards and associated costs are lower.

We must then add to the utility model to account for the creditor's entitlement to a claim against the estate on account of the amount avoided as a preference. The money returned by the creditor to the debtor pursuant to preference liability is, after all, rightfully due and owing, and the creditor is entitled to distribution

145. Bussel, *supra* note 73, at 14 (noting that preference law plays the necessary and important role of "controlling express opt-out behavior by in-the-know creditors, especially insider-creditors").

on account of that claim in liquidation or according to a plan of reorganization. The new calculation becomes:

$$R = (1-p)\, r + p\, (r - (l + d) + PR\, (l)).$$

In this equation, *PR* signifies the pro rata percentage that an unsecured creditor can expect from the bankruptcy estate as part of the overall creditor recovery.

Theoretically, a creditor would use this equation to weigh the expected returns of obtaining payment from the debtor when the debtor is insolvent against the expected returns of not seeking or accepting payment. Analysis of the equation quickly demonstrates that *R* is presumptively higher when a creditor collects than when a creditor does nothing. In fact, as creditors become more sophisticated, their expected return on collection over non-collection grows. This means that sophisticated creditors are less likely to be deterred by preference liability, and therefore more likely to pursue preference payments from the debtor in the days leading up to bankruptcy.

Collection is more profitable than failure to collect even if preference liability is a near-certainty, so long as the expected settlement payment and associated costs do not exceed the amount recovered from the debtor.

$$\text{If } r > (l + d), \text{ then } R > 0.$$

In other words, so long as creditors are careful not to spend more defending against preference liability than they can reduce their overall liability through negotiation with the trustee or the DIP, they will be better off taking the risk. Accordingly, a first level approximation of creditors' expected recovery indicates that sophisticated creditors who are efficient in their defense costs will always choose to accept or even demand payment from a debtor, however likely a resultant preference action may be. Of course, the less likely a preference action is, the higher the expected recovery.

Creditors generally can control the costs of defending a preference action. In addition, creditors will only need to incur such costs after bankruptcy has been filed. Accordingly, creditors may evaluate, based on factors informing the probability of a successful preference action and the likelihood of favorable settlement terms, how much to spend to maximize probable recovery. In cases where there is a low probability of defenses and low strategic power, the

creditor can expend little to nothing on a defense. In cases where the creditor is better able to exert influence or argue defenses, the creditor may expend more on costs to maximize recovery. Savvy creditors will not spend more than they expect to reduce their liability. In other words, creditors will ensure that

$$d \leq r - l,$$

such that attempts to collect $r$ will always result in a higher payout than doing nothing.

Although creditors cannot control or even always predict when preference liability may happen, they can reduce the likelihood that liability will result in a net negative by ensuring that costs of defense do not exceed the expected reduction in liability. As a consequence, even though creditors despise being targeted for preference actions, they do not reduce their collection activities in the face of possible preference liability. Even creditors who face liability do not regret having collected in the first place. When asked what they might have done differently to avoid liability, the only proposed change they would make in their behavior moving forward is to be more cautious in lending to other debtors who may eventually find themselves in bankruptcy.[146]

### *D. Empirical Findings*

Up to now, there has been a great deal of skepticism over the extent to which preference law is effective as a deterrent but little to no evidence establishing or refuting its effectiveness.[147] Information regarding the impact of preference law in the real world is notoriously difficult to obtain, in large part because so little of preference enforcement is in the court record. Many preference actions are settled before a complaint is even filed, leaving no

146. *See, e.g.*, Telephone Interview with PC (Sept. 14, 2017); Telephone Interview with PC-B (Sept. 7, 2017) ("[W]e're more risk-averse than we were, so that means companies that need help don't get as much of our expertise."). The Bankruptcy Code was amended in 2005 to include the value of goods received by the debtor in the twenty days before the bankruptcy filing as an administrative expense, in order to counteract the perceived reluctance to give even short-term credit to a company struggling with insolvency. *See* 11 U.S.C. § 503(b)(9) (2012).

147. *See* McCoid *supra* note 35, at 263 ("[T]estimony [that preference law is effective as deterrence] is generally either anecdotal or conclusory.").

evidence of the preference at all other than a record of potentially preferential payments in a debtor's initial disclosures.[148] In some cases, debtors may state in their Chapter 11 plan disclosure documents that preference actions have been considered but will not be brought to trial, with no explanation as to whether they were simply dropped or pursued and settled.[149] Previous efforts to study preferences have consistently run into this difficulty, and more empirical research on the topic is necessary.[150]

My primary goal in the instant study was to understand the effect of preference law on creditor behavior. In conducting my interviews, the opinions and observations I heard largely echoed the findings of a previous study on preferences conducted by the American Bankruptcy Institute (ABI) Bankruptcy Reform Study Project in 1995–96. The ABI had formed a Task Force to study preference law in response to concerns voiced over the perceived unfairness of preference law. As part of its study, the Task Force prepared two surveys, one directed at creditor providers and the other at bankruptcy practitioners, to elicit information and opinions on preference law.[151] Unsurprisingly, survey results indicated that credit providers were much more critical of preference law than practitioners, but both groups believed that preference laws penalized creditors who attempted to work with debtors by accepting settlements or workouts in the days prior to bankruptcy.[152] These findings suggest that the deterrent effect of preference law has been turned on its head—rather than discouraging creditors from dismantling the debtor in the days leading up to bankruptcy, it discourages creditors from working with the debtor

148. As part of a debtor's required schedules to be filed with the court, the debtor must provide a list of all transfers that have taken place within the previous ninety days. *See* U.S. COURTS, STATEMENT OF FINANCIAL AFFAIRS FOR NON-INDIVIDUALS FILING FOR BANKRUPTCY: OFFICIAL FORM 207 (Apr. 2016), http://www.uscourts.gov/sites/default/files/form_b_207.pdf.

149. *See, e.g.*, Debtor's Disclosure Statement at 17, *In re* Bermo Enterprises, Inc., Bankr. W.D. Mich. (2013) (No. 12-10207) (noting that debtor's rights to avoidance actions are preserved, but releasing, without explanation, all avoidance claims except for a specified group); *cf.* Busick Insulated Glass, Inc.'s Second Amended Disclosure Statement for its Second Amended Plan of Reorganization at 7, *In re* Busick Insulated Glass, Inc., Bankr. W.D. Mich. (2013) (Doc. 142) (reporting settlement amount and decision not to pursue alternative actions in light of likely defenses).

150. Ponoroff, *supra* note 2, at 346, 356.

151. *See* ABI PREFERENCE SURVEY, *supra* note 53, at 2.

152. *See id.* at 2.

to avoid premature dismantling.[153] My research sought to better understand how preference law impacts creditor behavior through in-depth interviews with individuals who had recently been part of a Chapter 11 case.

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 and $100 million that also listed unsecured trade creditors in their schedules. Within this sample, I looked for companies that had filed a preference action against a creditor, searching within court documents for any reference to § 547 (the Code section for preference avoidance).[154] I excluded cases that ended in liquidation of the debtor's assets, although I included cases where the company was sold as a going concern. 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. I excluded creditors located outside the United States, taxing entities, insiders, creditors subject to an action under § 544,[155] and judgment creditors.[156]

153. As much has been suggested by other scholars as well. *See* McCoid, *supra* note 35, at 261 n.78 (noting that preference may be given by the debtor to induce a creditor to come to the debtor's assistance and facilitate rehabilitation, but possible avoidance of such a preference weakens the debtor's ability to use it as an incentive); *see also* Denney v. Dana, 56 Mass. (2 Cush.) 160, 171–72 (1848).

154. The Bankruptcy Code contains additional provisions that allow a trustee to sue creditors for similar causes. *See, e.g.*, 11 U.S.C. § 553(b)(1) (2012) (allowing the trustee to recover the amount offset by a creditor in the 90 days before bankruptcy on a preference-like analysis). However, I did not target these provisions for consideration in my study.

155. Creditors may be liable under 11 U.S.C. § 544 if they have not perfected their otherwise valid security interests prior to the bankruptcy filing. Pursuant to § 544 of the Bankruptcy Code, 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.

156. 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 mailed introductory letters to the remaining creditors, as well as to the debtor and all attorneys of record. I sent mailings one case at a time, beginning with the five most recent cases and then proceeding in alphabetical order until I had sent mailings to around 350 individuals. A few weeks later, I attempted to call the individual creditors, debtors, and attorneys for whom I could locate telephone numbers.[157] If I was successful in reaching an individual, I made the request to interview them for this study.[158] 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.

Through these efforts, I was able to obtain complete interviews from forty-eight individuals, including twenty-eight creditors, three debtors,[159] and seventeen attorneys.[160] Of the creditors who consented to be interviewed, eleven had themselves been the subject of a preference action. Of the attorneys interviewed, all had experience with preferential transfers, albeit on different sides of the aisle and at different times. Ten of the attorneys represented the debtor in the case that was the subject of the study, and the remaining seven represented a creditor, although most of the attorneys represented a mix of debtors and creditors in bankruptcy cases over the scope of their careers.[161] 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. The interviewees represented a diverse population geographically. They hailed from eighteen different states, including New York, Florida, and California, as well as Kansas, Michigan,

157. 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.

158. As per University protocol, I obtained advance approval for this study from the Institutional Review Board. Documentation on file with the author.

159. The ratio of debtor to creditor interviews largely reflects the overall ratio within cases. Obviously, each individual debtor had multiple creditors.

160. One attorney interviewed was referred by another study participant, based on his experience and familiarity with preference actions, and so was not contacted by virtue of his involvement in one of the sample cases. 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.

161. Attorneys who agreed to a formal interview represented a combined 515 years of experience in insolvency proceedings.

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

In preparing for and conducting these interviews, I was aware of the danger that, through my questions, I might impose my own views or suggest desired responses. Accordingly, I relied primarily on broad, open-ended questions, asking for more specific details only when I did not fully understand the responses given. Questions differed depending on the participant. For creditors and debtors, I asked for information specifically relating to the particular case in which they had been involved. For example, I asked the creditors whether they were surprised by the debtor's decision to file for bankruptcy, how the debtor's bankruptcy had affected their own business, and whether they were satisfied with the outcome of the bankruptcy. I asked debtors how they made the decision to file for bankruptcy and how they made the decision whether or not to bring a preference action against creditors. I asked attorneys for their general observations based on experiences across bankruptcy cases (in part to avoid concerns regarding confidentiality for any given case), whether creditors were likely to predict a preference action and whether, in their view, such a prediction deterred attempts to collect.

Interview responses reflected a variety of experiences, which one would expect from a diverse group of individuals, but several common themes developed quickly and consistently from the collected statements of interviewees. First, debtors seem to bring preference actions only against those creditors who are less necessary for the debtor's ongoing survival.[162] In other words, debtors will target creditors who are less useful or less important to the debtor. Further, attorneys reported that it was extremely rare to see a preference action brought against any creditor during a "true"

162. *See* Telephone Interview with CA (May 25, 2017) (filed preference actions either when significantly large or when the debtor "didn't really care about the creditor anymore, didn't need the creditor's support"); Telephone Interview with CA (May 18, 2017) (noting that client subjected to preference action was a "sacrificial lamb" that the debtor no longer required); Telephone Interview with PC (June 19, 2017) ("There were [other] people who were given preferential treatment and they never got lawsuits against them at all.").

Chapter 11 reorganization and that such claims were typically only exercised in Chapter 7 or in a Chapter 11 liquidation.[163] As expressed by one debtor's attorney,

> if 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 to repay $50,000. Especially if your Plan's been confirmed. . . . But, you do see it a lot in the liquidation cases.[164]

When claims are brought in a Chapter 11 reorganization, they are typically brought at the end of the case by a third party, such as the head of a liquidating trust or the creditor's committee.[165]

Second, larger, more sophisticated creditors anticipate and respond to preference claims differently than smaller, less sophisticated creditors. Larger creditors frequently employ in-house credit managers to monitor their lines of credit and payments.[166] These creditors, by virtue of the monitoring and experience, are frequently able to confidently predict a possible

163. *See* Telephone Interview with CA (May 30, 2017) ("[I]n 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, because he's not going to pursue the preference action against a party that is needed for the business, if there is an ongoing business."); Telephone Interview with DA (June 6, 2017) ("I can't think of a Chapter 11 that I have filed in the last five years where there was a lot of preference action.").

164. Telephone Interview with DA (May 19, 2017); *see also* Telephone Interview with DA (May 25, 2017) ("[T]ypically, in a true reorganization as opposed to a sale case or a liquidation . . . you normally give up, waive, any right to bring preference actions as part-and-parcel of your confirmation process.").

165. *See* Telephone Interview with CA (July 26, 2017) ("[I]f preference actions are going to be pursued. . . [i]t's not going to be by the debtor, it's going to be by a third party . . . commonly a liquidating trust."). This finding was somewhat inconsistent with the results of the 1997 survey distributed by the ABI, which suggested that preference litigation is—or was—fairly frequent, even in Chapter 11 cases pre-confirmation. ABI PREFERENCE SURVEY, *supra* note 53, at 7 (indicating that over 70% of practitioners said preference litigation was commenced sometimes or frequently in Chapter 7 and post-confirmation in Chapter 11, and over half responded in like fashion for Chapter 11 pre-confirmation). This inconsistency might be explained by the fact that the ABI survey did not distinguish between reorganizing and liquidating Chapter 11 cases in its question, and the fact that liquidating Chapter 11s have become increasingly common in the intervening decades. *See* Chad P. Pugatch et al., *The Lost Art of Chapter 11 Reorganization*, 19 U. FLA. J.L. & PUB. POL'Y 39, 61-63 (2008).

166. That said, size did not always signal sophistication. In at least one instance, a smaller employer with less than ten employees, nevertheless, hired a credit management company and obtained insurance to cover any loss in sales. Furthermore, this employer established payment terms that protected the creditor against the possibility of preference liability. *See* Telephone Interview with C-N (May 22, 2017).

bankruptcy filing.[167] As noted by one creditor, "as a customer's payment pattern slows down and their invoices are aging further and further and their explanations are weaker and weaker, it becomes kind of clear, in most instances, what is going on before they pull the trigger on the bankruptcy."[168] In addition, more sophisticated creditors are more likely to be aware of preference law, even if they do not register that any given payment will be a potential preference until after the bankruptcy filing.[169] On the other hand, smaller creditors with fewer administrative staff were much more likely to report being surprised by the bankruptcy, even

167. *See* Telephone Interview with C (Aug. 28, 2017) ("You tend to learn what happens when a customer is starting to have problems."); Telephone Interview with C (June 7, 2017) ("Usually, when we start running into payment issues like this and it gets this far this quickly, then yeah, it's not a big surprise."); Telephone Interview with C (May 18, 2017) ("[A]nytime anybody files for bankruptcy . . . there's always a pattern that we see. Kind of a payment pattern. It takes them longer to respond. It's more of a payment history pattern that starts to change."); Telephone Interview with CA (Aug. 8, 2017) (noting that trade creditors usually see the bankruptcy coming); Telephone Interview with CA (June 6, 2017) ("Oh, you can tell when a bankruptcy is coming."); Telephone Interview with DA (June 20, 2017) ("Oftentimes, it's not a surprise because more sophisticated trade creditors can see the warning signs."); Telephone Interview with DA (June 19, 2017) ("For my clients who tend to be sophisticated, it's typically less of a surprise and no longer a traumatic or stigma or issue associated than it was . . . years ago, when I started."); Telephone Interview with PC (July 14, 2017) ("[W]hen someone is filing for bankruptcy we usually get some notice beforehand that we try to reduce the balance as quickly as possible."); Telephone Interview with PC (July 11, 2017) ("[W]hen you start seeing a company that is rolling out farther and farther and farther on their payments, and the things that we have in place to monitor accounts, generally it's not a huge surprise to us when it happens."); Telephone Interview with PC (June 1, 2017) ("Usually, our credit and collections manager is very good at predicting bankruptcies. Very good. We usually see them coming to be honest.").

168. Telephone Interview with C-VK (June 6, 2017).

169. *See* Telephone Interview with CA (Aug. 8, 2017) ("The smaller trade creditors generally didn't see it coming unless they had a lawyer."); Telephone Interview with CA (June 21, 2017) ("If [creditors are] sophisticated, meaning they've been sued before, then they go 'oops' when they get the filing. . . . If they haven't been sued before then sometimes the demand letter from the debtor or the liquidating trustee is the first they know about it."); Telephone Interview with CA (May 25, 2017) (indicating that creditors are "not thinking, 'I have now gotten a preference action' even though they may have a chief financial officer who certainly knows about preferences"); Telephone Interview with DA (Aug. 31, 2017) ("[A]ny savvy creditor would be sensitive to preferences . . . . [, b]ut I guess [mom-and-pop creditors], . . . they don't have the same sophistication, or they haven't been down that path before. You go down that path once, you'll never be surprised by it again."); Telephone Interview with DA (June 20, 2017) ("The sophisticated ones know what's coming, and the ones that are less sophisticated or haven't been through the process are often surprised by [preference claims]."); Telephone Interview with DA (May 25, 2017) (observing that sophisticated creditors "are very well aware of preference actions and the risk that they might be brought at some point either during or after the case").

if they had noticed the debtor was behind on its payments.[170] Preference actions were especially shocking,[171] particularly to creditors who had engaged in pre-filing negotiation and even settlement talks with a debtor to resolve the outstanding account.[172]

The stories given by smaller creditors were telling. One creditor who headed a firm of less than fifteen employees reported that he had just established a payment plan with a debtor shortly before the debtor filed and was shocked, after the bankruptcy filing, to receive a demand for all of the money he had been paid under the negotiated payment plan. He observed that "big corporations . . . have figured out a way to protect themselves. Small guys like me, who take you on your word, have no protection."[173] Another creditor with a similarly sized firm reported that the debtor contacted the creditor in advance of the bankruptcy to assure that the creditor's debt would be satisfied without the necessity of a mechanic's lien (which may be exempt from preference litigation)[174] to which the creditor would have been entitled. On account of the call, the creditor forbore from obtaining the lien only to receive a notice of the bankruptcy shortly after.[175] A third creditor, with less than ten employees, reported being contacted by the debtor with an offer to settle for half the debtor's outstanding balance of $20,000. The creditor accepted the offer "because I didn't think this company would last," and was astounded to receive a demand in the debtor's bankruptcy case, not just for the settlement

170. *See* Telephone Interview with C-BC (July 14, 2017) ("The big guys, you can usually see [the bankruptcy] coming. . . . With the smaller guys you wake up one morning and they're out of business."); Telephone Interview with C-E (May 22, 2017) (expressing surprise at the bankruptcy despite knowing the debtor was in trouble, but expecting the debtor to work it out); Telephone Interview with CA (May 18, 2017) ("You've got to be a fairly big, a fairly good size vendor in order to have a collection department, that can anticipate a potential bankruptcy, and make changes in their way of doing business to avoid a preference action."); Telephone Interview with PC (Aug. 31, 2017) (noting surprise about the bankruptcy, especially since debtor was ordering product until the week prior); Telephone Interview with PC (June 19, 2017) ("I had no clue that that would ever happen.").

171. *See, e.g.*, Telephone Interview with PC (June 19, 2017).

172. *See* Telephone Interview with C-R (May 22, 2017).

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

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

175. Telephone Interview with C-R (May 22, 2017) ("A month later all of a sudden, we get a letter that we're included in the bankruptcy and now he won't take the owner's phone calls.").

amount but for additional amounts received previous to the settlement.[176] "So, they sued for preferential payment. Like I said, we're the small guy, we're the last one to get paid. So, for us to get preference payment is ridiculous. . . . It was so bad. It was disgusting, you know?"[177] The preference action was settled for less than half of the preference claim, but the owner maintained, "I still think it completely unfair."[178] Without a sophisticated understanding of the system, these creditors also felt that they were less successful in challenging or settling preference claims than larger or better informed creditors.[179] Smaller creditors frequently reported feeling that they had been disadvantaged by a system of which they were largely ignorant and that other creditors were left significantly better off.[180] Evidence suggests that these perceptions were not without basis.[181]

The final, and perhaps most telling, observation across interviews was how creditors reacted to the threat of preference actions. Universally, creditors accepted—and even encouraged—payments from the debtor, even if they anticipated possible preference liability would follow.[182] Further, they were advised by

176. Telephone Interview with PC (May 20, 2017).

177. *Id.*

178. *Id.*

179. *See* Telephone Interview with PC (Aug. 31, 2017) ("I would have had to get a lawyer, go all the way up [to a different state for the hearing] . . . . [S]o now I'm paying a lawyer, taking time out of work; by the time I'm done I'm going to lose more than [what] they owed me. But I think that's what [their goal was.]"); Telephone Interview with PC (June 19, 2017) ("They're just wringing everything they can out of you and they want to know your top dollar and to see how far they could get.").

180. *See* Telephone Interview with PC (June 19, 2017) ("There were people who were given preferential treatment and they never got lawsuits against them at all. . . . Because they were actually given preferential treatment. We were not one of those people, just for the record.").

181. *See* Telephone Interview with DA (July 14, 2017) (noting that the settlement amount "depends on the facts, of course, and it depends on how savvy the creditor is. . . . I've seen some creditors will just pay back money without getting into it—they don't want to deal with the lawsuit."); Telephone Interview with DA (June 23, 2017) ("[T]ypically, smaller companies will want to negotiate something, say, '(1) we don't want to spend much money on legal fees; (2) we can't pay you anyway, so let's cut a deal.'").

182. *See* Telephone Interview with C-BC (July 14, 2017) ("We wouldn't back off on collection efforts. I might change their terms to COD . . . [and decline when the debtors] want you to apply it to the past due."); Telephone Interview with PC (July 14, 2017) ("We just try to get as much cash as we can, as quickly as we can while we know somebody is going downhill. Or at the very least, our rule of thumb is, let's at least freeze the balance so it doesn't get any higher."); Telephone Interview with PC (July 11, 2017) (explaining that, if an account

their attorneys to do exactly that, to "take the money and run[.] It's always better to have the money in hand than not."[183] Literally every attorney responded to inquiries with similar advice: "[E]very creditor lawyer that you'll talk to will say 'take the money. We can always pay it back. Do not refuse money and take the money and we'll deal with it on the backside under the statute.'"[184] The shared perception was that creditors would still be better off taking the money even with a subsequent preference demand, since the trustee would invariably settle for a return of some portion—perhaps half—of the preferential transfer.[185]

Particularly for more sophisticated clients, this advice might be followed by the suggestion that a transaction be made as close to the ordinary course as possible, or otherwise positioned to fall into

is starting to extend, the creditor reduces credit limit and sends representatives over to collect in person); *see also* Telephone Interview with CA (June 21, 2017) ("[I]f . . . they see a bankruptcy coming" they think, "'we better start getting paid on our invoices timely.'"); Telephone Interview with DA (June 20, 2017) ("[S]ome creditors take the approach of 'I'd rather have the money and we can fight over it later' and put pressure on to get payment if they see a bankruptcy coming.").

183. Telephone Interview with CA (May 30, 2017).

184. Telephone Interview with CA (May 25, 2017); *see also, e.g.*, Telephone Interview with CA (Aug. 8, 2017) ("[I]f you can extract some payments . . . if you have the negotiating leverage to get that, get it."); Telephone Interview with CA (July 26, 2017) ("I think the rule is: take the money and run. Do whatever you can to limit your preference risks, but having said that . . . . [t]ake the payment and deal with the preference risk another day, which may be two years from that day."); Telephone Interview with DA (Sept. 8, 2017) ("[I]f they're going to pay you—take the money. I always tell clients, take the money. You may have preference exposure, but take the money for now and we'll see what happens."); Telephone Interview with DA (July 17, 2017) ("It's always wise for the creditor to take a preference. . . . Because if you can get the money, you can defend it later."); Telephone Interview with DA (July 14, 2017) ("If your choice is either take the money now or not get money before a case, you take the money now."); Telephone Interview with DA (June 23, 2017) ("I think everybody would give the same advice. Take the money. Take the money. Take the money. Worry about it later."); Telephone Interview with DA (June 19, 2017) ("Always take it. . . . Always better to take and have to give back than never take it at all."); Telephone Interview with DA (May 25, 2017) ("[T]he worst you're going to have to do is give the money back, but take the money.").

185. *See* Telephone Interview with C-BC (July 14, 2017) ("Say if you're sued for a ten-million-dollar preference claim, you . . . can settle for a hundred thousand if you have your ducks in a row."); Telephone Interview with CA (June 6, 2017) ("[Y]ou may have to give back fifty, sixty, seventy cents of it. But you'll get something on it."); Telephone Interview with CA (June 6, 2017) ("[Y]ou always take a preference. . . . [Y]ou're going to have to give back part of it. Preferences, in the practical scheme of things, they'll take fifty cents on the dollar back, sixty cents."); Telephone Interview with DA (June 6, 2017) ("They always settle, and they always settle for 40 to 60 cents.").

one of the preference law defenses.[186] Several creditors discussed the possibility of attempting to convert outstanding amounts owed as accounts receivable into a new note for repayment in the ordinary course, or otherwise shielding the old debt with newly secured debt.[187] Structuring payments through a third party, such as a credit card company, was also discussed as a possible response to guard against the threat of preference actions.[188] Another tactic used was to enter into an agreement with the debtor that, in exchange for a reduced settlement of the amount owed, the debtor would commit to not file bankruptcy for ninety-one days after receipt of payment.[189] Although some of these tactics seemed more likely to succeed than others, they all represented at least an awareness and intent to preempt preference liability.

Perhaps the most common response when creditors anticipated a bankruptcy filing was to simply stop extending credit to the debtor and proceed on a cash basis going forward.[190] This tended to be the approach of all creditors interviewed who had recently experienced preference liability for the first time. Being previously unaware of such a possibility, they responded going forward by restricting terms on all their debtors, whether it appeared they

186. *See* Telephone Interview with CA (May 30, 2017); Telephone Interview with DA (July 14, 2017) (taking the preference, "you may be able to have ways to arrange for your payment in a way that doesn't expose you to preference"); Telephone Interview with DA (June 20, 2017) ("Some will try to manipulate the allocation of the payment, to try and get it outside of preference wording.").

187. *See* Telephone Interview with CA (June 6, 2017) ("Sure, they're ways to get around it. I mean, you can advance them new money and take a security interest and incorporate that debt into the new money."); Telephone Interview with PC (June 1, 2017).

188. *See* Telephone Interview with CA (July 26, 2017) ("Do they try to move the payment form from a paper check to a credit card, or change the party paying the past due invoices? And can we get a third party in the form of a customer's lender to buy the invoices perhaps at a discount that still take out the problem of the preference risk[?]"); Telephone Interview with CA (May 18, 2017) ("[Y]ou may even . . . see if there's a way to structure payments from a non-bankruptcy entity, so to speak.").

189. In the event of breach, the full amount of the debt would be reinstated as a claim against the estate. *See* Telephone Interview with DA (June 20, 2017).

190. *See* Telephone Interview with C (Aug. 28, 2017) ("[Y]ou can stop shipping them on terms and make them pay in advance for their orders or not ship them at all."); Telephone Interview with C (June 7, 2017); Telephone Interview with C-B (July 14, 2017) ("[W]e actually ask for money upfront before we send the merchandise out."); Telephone Interview with PC (July 14, 2017) ("We usually do it by trying to tighten up the payment plan. In other words, all credit terms stop."); Telephone Interview with PC (July 11, 2017) ("[I]f they're not paying they go on cash/check/credit card.").

would file for bankruptcy or not.[191] Creditors might also be quicker to act on legal rights in future cases to outrun other creditors or collect before the ninety-day period would run.[192] Obviously, these responses are inconsistent with the stated deterrent intent of preference law, which was to provide the debtor with greater breathing space and avoid pressuring the debtor into a bankruptcy filing. The threat of preference actions does not discourage creditors from accepting and even encouraging cash payments. Instead, it encourages creditors to insist on strictly cash moving forward, and to tighten up lending terms with debtors they believe are a risk. This constraint on a debtor's liquidity can only contribute to, not deter, a bankruptcy filing.

## VI. PROPOSED ADJUSTMENTS

If the purpose of preference law is to discourage only "unusual" collection efforts that demonstrate "opt-out behavior,"[193] it fails, in large part because it does not target such behavior. Instead, it casts a sweeping net that allows savvy creditors to escape its grasp and leaves less-savvy creditors to take the hit. If the purpose of preference law were instead to discourage *all* creditor collection in the days leading up to bankruptcy by virtue of a shotgun approach, it still fails, because the risks of being the target of a preference action combined with the expected penalty associated with preference liability, do not outweigh the benefits of collection.

It is possible that, despite its failure on such stated goals, preference law is nevertheless defensible as a deterrent to

191. *See* Telephone Interview with PC (May 20, 2017) (cut next struggling debtor off months ahead of the eventual bankruptcy); Telephone Interview with PC (May 22, 2017) ("So, it makes you wonder, as you go for in business, is what it does. It 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. I got most everybody is on a cash basis. You want it, you pay me and you get it . . . . Nobody's ever owed me that much money again. . . . You just lock them into thirty days, and if they don't you just cut them off. It's just not worth the risk.").

192. *See* Telephone Interview with C-R (May 22, 2017) ("If we get that sort of a vibe we're much quicker to go after a mechanic's lien or we've taken several customers to court to go ahead and get claims against them and judgments before any of this happens."); Telephone Interview with PC (June 1, 2017) ("We're definitely more aggressive in our collection efforts.").

193. *See* Afilalo, *supra* note 44, at 635; Bussel, *supra* note 73, at 14.

bankruptcy itself. If creditors are aware that preference liability only operates within bankruptcy,[194] they may discourage the debtor from filing in whatever way they can, perhaps by conditioning negotiations or settlement on the debtor staying out of bankruptcy. In this way, the law of preferences may operate as a sort of bankruptcy tax on unsecured creditors.

Alternatively, preference law may operate as a deterrent to unsecured credit. As described above, fully secured creditors are immune from preference liability, even though they are the most able creditors to push a debtor into bankruptcy by threatening or effectuating collection. Preference law may be viewed as encouraging more lending arrangements on a secured basis. Of course, this does nothing to answer the demands of involuntary creditors, such as tort victims, who typically lack the ability or the luxury to obtain security. To the extent unsecured credit is not deterred, preference law may operate to encourage greater monitoring of debtors, necessitate the retaining of counsel in bankruptcy, and require creditors to take other precautions regarding unsecured debt.

To be sure, none of these benefits were addressed by Congress in the passage of preference law, although it is at least theoretically possible that lawmakers could or would view them as desirable goals and consistent with an overarching trend in favor of secured credit to the detriment of unsecured credit. Nevertheless, preference law is a clumsy tool to accomplish these benefits, as demonstrated by the weaknesses outlined above, and likely unnecessary in light of strong state support for secured credit. If Congress wishes instead to use preference law to avoid the premature dismantling of companies or raiding of assets by favored creditors, I would recommend a tailoring and narrowing of preference law to more carefully target actors with the ability to harm debtors in this way, and then to increase the penalty associated with the harmful behavior.

194. *See* Skeel, *supra* note 119, at 492–93 (observing the inconsistency in preference law between state and federal law).

### *A. Discrimination Between Creditors*

In practice, preference law distinguishes between creditors based on their value to the debtor and their level of sophistication about the law, rather than engagement in behavior Congress thought to be harmful.[195] To be effective, laws seeking to deter creditors from particular behavior must effectively single out individuals engaged in that behavior and not punish behavior that was not intended to be targeted. Accordingly, to make preference law a viable means of deterrence, I would only impose liability on those who have the leverage needed to "push" a debtor into bankruptcy or, in the case of insiders, gut the company during its slide.

#### *1. Insiders*

Even among those predisposed to dislike preference law, there is a general sense that it is appropriate to reclaim transfers made to insiders in the days leading up to a debtor's bankruptcy filing.[196] In some ways, this is a principle of fairness—the insiders are usually the parties viewed as most capable of preventing a bankruptcy and, if they have failed to do so, they should pay the consequences for the failure along with other creditors. Under this view, it is inherently unfair that insiders should receive payment on their debts while the debtor has creditors who are left unsatisfied.[197]

There is also the concern of deterrence against fraudulent activities. Insiders typically determine which creditor to pay first. Insiders also typically have the best information regarding financial distress within a company and may therefore have both the incentive and the opportunity to bleed a company of its assets ahead of other creditors. To the extent this activity is fraudulent, it could be targeted and reversed pursuant to the avoidance of fraudulent transfers,[198] however, fraud may be difficult to prove. In

195. *See supra* note 62 and accompanying text.

196. As defined by the Bankruptcy Code, insiders include relatives or general partners of the debtor, directors, control persons, and others in similar positions. *See* 11 U.S.C. § 101(31) (2012).

197. *See* Telephone Interview with PC (Sept. 14, 2017) ("I was just the business; I was just selling product. There was no relationship there; there's no family member, no nothing.").

198. *See* 11 U.S.C. § 548 (2012).

light of this, the return of payments made to insiders during a given period—preference law places it at one year prior to the bankruptcy—is likely appropriate. In order to be a deterrent, liability should exceed the value of the preferential transfer.

The primary concern with allowing increased liability against insiders is that insiders who have received preferential payments might hesitate to file for bankruptcy on behalf of their company or might wait and file at a time that is less likely to expose insiders to liability, but also less likely to result in a successful reorganization. Such a disincentive operates under the current bankruptcy law, although it is unclear the extent to which it affects the decision to file for bankruptcy.[199] However, states impose liability on transfers made to an insider while the debtor was insolvent pursuant to prohibitions on fraudulent conveyance.[200] Accordingly, insiders would have reason to anticipate a demand for transfer in any case.

*2. Undersecured creditors*

Creditors who have a security interest associated with their outstanding debt, but who are owed more than the value of their collateral, are commonly referred to as "undersecured" creditors. Outside of bankruptcy, the undersecured status has relatively little significance, other than the fact that the creditor is likely to be left with a deficiency even after foreclosing on collateral. Within bankruptcy, however, an undersecured creditor's claim is bifurcated into a secured and unsecured portion, leading to some increased complexity regarding the treatment of that claim. Undersecured creditors retain a claim against their collateral, but also hold an unsecured claim that will be paid out on a pro rata basis with other unsecured creditors. Although fully secured creditors are not subject to preference liability, undersecured creditors may be if a transfer from the debtor reduces the unsecured portion of their claim against the bankruptcy estate.

From the perspective of deterrence, any creditor with a security interest in a debtor's collateral, whether or not the debt is fully

199. *See* Michelle M. Harner & Jamie Marincic Griffin, *Facilitating Successful Failures*, 66 FLA. L. REV. 205, 223 (2014) (discussing other heuristics and biases influencing management's decision to file for bankruptcy or not).

200. *See* Uniform Fraudulent Transfer Act (UFTA) § 4(b)(1). This model act has been enacted in forty-three states.

secured, is more likely to have the leverage necessary to "push" a debtor into bankruptcy and is therefore a worthier target of laws that would discourage the creditor from taking steps to foreclose. Foreclosure—the seizure and sale of debtor property—certainly constitutes an action outside the ordinary course of business, and one that is very likely to have a negative impact on the debtor's ability to function. Further, foreclosure is a value-destroying process, where collateral may be sold for a small fraction of its true worth. Accordingly, as far as collection practices go, creditors with the power to foreclose against a debtor's property should be high on the list of those Congress would wish to deter, to better encourage successful reorganizations.

It is perhaps ironic, then, that secured creditors generally are not subject to the deterrent force of preference law. Foreclosures of property in full satisfaction of a creditor's debt will be upheld if they are completed prior to a bankruptcy filing. However, to the extent a creditor receives payments from the debtor that would reduce the unsecured portion of a creditor's debt, such payments should be subject to deterrence through preference liability. An undersecured creditor is at once secured and unsecured but should not be permitted to exert the force of its security interest against the unsecured portion of its debt. Payments to an undersecured creditor in the run up to bankruptcy are presumably made in preference to other debts in order to avoid foreclosure. Undersecured creditors should be deterred from forcing such payments by relying on their secured status and should therefore be subject to preference liability if their unsecured debts are reduced via a transfer from the debtor in the ninety days prior to bankruptcy.[201]

*3. Tardily secured creditors who use security to coerce or foreclose*

A similar analysis applies to creditors who hold outstanding unsecured debt and then receive a security interest within the preference period, transforming them from unsecured to secured creditors at a time when the debtor is presumed to be insolvent. By

201. Creditors who are technically fully secured at the time of bankruptcy on account of payments made to reduce unsecured debt within the preference period but who otherwise would have been undersecured should also be subject to preference liability for the same reasons.

virtue of obtaining a security interest, such creditors have established a higher degree of leverage over a debtor, including a more realistic ability to force the debtor into bankruptcy proceedings. To the extent preference law is concerned with the exercise of such leverage it should permit a debtor to strip security interests granted or perfected in the ninety days before bankruptcy. The reason for treating perfection as an act of transfer is explained in the different treatment given to perfected and unperfected liens. Unperfected liens will not stand up to competing claims, including those raised by a bankruptcy trustee.[202] Unperfected security interests, or "secret liens," should be discouraged to avoid allowing creditors to force last minute pre-bankruptcy concessions from the debtor.[203]

Like other secured creditors, even tardily secured (or perfected) creditors have the power to foreclose against the debtor's property, which is the leverage needed to force a debtor into liquidation proceedings or undermine reorganization efforts. However, late-perfected creditors only obtain this power (presuming insolvency in the ninety days before bankruptcy) after the debtor becomes unable to pay his or her debts as they come due. To the extent Congress wants to discourage actions that torpedo a debtor's chances for survival during a period of insolvency, the act of obtaining such leverage clearly qualifies.

*4. Judgment creditors*

The congressional record, with its specific reference to a "rac[e] to the courthouse,"[204] appears to signal that judgment creditors were intended to be targeted and deterred by preference law. Discouraging judgment creditors from obtaining or executing a judgment on the eve of bankruptcy can be justified by the pressure such judgments place on the debtor, especially by locking up essential collateral. In addition, such judgments can be seen as

202. *See* discussion *supra* note 155 (regarding a trustee's strong-arm powers pursuant to 11 U.S.C. § 544).

203. *See Brave New World supra* note 43, at 445, 449 (suggesting that secret liens may be deliberate, and that the thirty-day rule in § 547(e)(2)(A) "empowers unperfected secured creditors to get more than they could have under state law and allows them to make pre-bankruptcy grabs").

204. H.R. REP. NO. 95-595, at 177–78 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6138.

incompatible with principles of judicial economy. Obtaining and executing on a judgment on the eve of bankruptcy is, in retrospect, wasted effort because the creation of the bankruptcy estate itself ensures that all claims will be acknowledged, whether or not they are reduced to judgment,[205] and that the estate will be managed and liquidated in an orderly fashion, overseen by the bankruptcy court. Preference law can discourage a creditor from forcing the duplication of judicial effort by ensuring that a judicial ruling on a claim against a debtor will provide the creditor no advantage. Rational creditors will not take on the costs associated with obtaining and enforcing a judgment if those costs will leave them no better off in the end.

Recognizing this argument, I am nevertheless troubled by the fact that preference law's deterrent effect on obtaining judgments against insolvent debtors runs directly counter to state statutes of limitations encouraging creditors to exercise their rights against debtors in a timely fashion. In addition, the application of preference law to a judicial lien has been specifically objected to by credit providers, suggesting that many view this provision as particularly unfair.[206] Perhaps the perceived unfairness comes from the fact that the creditors have rightfully invoked the power of the state, and would be reasonable in assuming that power to be paramount; in fact, the judgment lien can be undone by bankruptcy law. Perhaps the sense of unfairness arises because the creditors who often take advantage of the courts do so because they have no other means of leverage or influence over the debtor and may in fact be tort victims with no other means of collection. It may be that congressional efforts to discourage a race to the courthouse are inappropriate when a creditor has no alternative path, but the legislative history on preference law currently makes no allowance for such a distinction.

*5. Disproportionately large transfers*

Finally, preference law should claw back the transfer of a disproportionate portion of the debtor's assets to satisfy a pre-existing, unsecured debt, particularly in cases where the debtor is

205. *See* 11 U.S.C. §§ 101(5), 502(a) (2012).
206. ABI PREFERENCE SURVEY, *supra* note 53, at 15.

left unable to operate as a consequence. Giving up significant amounts of the debtor's operating cash is likely to leave the debtor vulnerable to liquidation and unable to successfully reorganize, perhaps just as effectively as would foreclosing on essential collateral. Accordingly, such behavior should be targeted and deterred.[207] The appropriate threshold for how large a cash transfer must be to invoke liability is likely to be a fact-specific inquiry, depending on the size of the debtor and the nature of the debtor's business. For ease of enforcement, the law may incorporate a standard comparing the size of the transfer to the debtor's overall liquid assets, or something similar. Such a standard would be more effective in targeting behavior than simply establishing a minimum dollar amount.[208]

In establishing liability for these transfers, preference law could both support and be supported by provisions that allow for the avoidance of fraudulent conveyances in bankruptcy. Bankruptcy trustees are permitted to avoid transfers made by the debtor with "actual intent to hinder, delay, or defraud" a creditor, or transfers for which the debtor received "less than a reasonably equivalent value" in exchange.[209] This ability arises both under the Bankruptcy Code, and by virtue of the trustee's ability to exercise the rights of any creditor under state law and raise state law causes of action to avoid fraudulent conveyances, which may have a longer lookback period.[210] However, the burden of proof for fraudulent conveyances is much higher than for preferential transfers,[211] and it is often easier and less time consuming for a trustee to simply bring a preference action, if the transfer is within the relevant period.

207. It is worth noting that other areas of the Bankruptcy Code deal with a creditor's exercise of setoff rights, which frequently affect a debtor's operating capital. *See* 11 U.S.C. § 553(b). I would leave these provisions largely untouched.

208. *See* Bussel, *supra* note 73, at 12.

209. 11 U.S.C. § 548.

210. *Id.* § 544.

211. *Compare* 11 U.S.C. § 547, *with* § 548. Fraudulent conveyance law typically requires a finding of intent to hinder, delay, or defraud, which need not be present in preference actions.

### *B. Impose a Deterrent Penalty*

Once liability has been limited to the parties listed above, that is, insiders, partially or recently secured creditors, judgment creditors, and recipients of a substantial portion of the debtor's assets in the days leading up to bankruptcy, the law is better able to justify imposing a true deterrent effect. The justification for avoiding transfers to these individuals is more concrete, and the offending behavior more specific. Accordingly, the individuals can be expected to anticipate, and thereby avoid, a transfer that would violate the law.[212] However, avoidance will only be rational if the probability of liability combined with the severity of punishment work together to outweigh the benefit of the targeted behavior. Under current preference law, creditors remain undeterred because the costs of liability systematically fall below the benefit of collection, regardless of how certain liability may be.

To further increase the deterrent effect of the law, I would therefore recommend attaching a penalty to preference liability beyond simply returning the original transfer. McCoid has previously recommended that increasing the sanction to "two or three times the amount of the preference" would undoubtedly have a more deterrent effect on creditors subject to liability,[213] although the exact percentage, fine, or additional punishment needed to effectively deter targeted behavior may be much less than that.

As a caveat, I make this recommendation solely on the basis of the theoretical framework laid out by Becker, not based on my findings in the fields. By limiting myself to interviewing trade creditors, I did not obtain first-hand information as to whether the individuals I would target for preference liability are currently deterred, even without an associated penalty. It is conceivably possible that partially secured creditors are already discouraged from accepting payments from an insolvent debtor to reduce the amount of their unsecured debt potential or that secret lien holders, as a group, do not attempt to perfect a pre-existing security interest of an insolvent debtor. It may be that judgment creditors are

212. The risk that the law be seen as simply part of a broader Communist plot is therefore ameliorated. *See* Telephone Interview with CA (May 30, 2017) (explaining the difficulty of explaining the preference law to clients).

213. McCoid, *supra* note 35, at 270.

already discouraged from bringing suit against an insolvent debtor on the rationale that the effort will be largely wasted as a consequence of the debtor's immediate bankruptcy filing, even if they are successful in obtaining a judgment and a subsequent lien. It would be extraordinarily difficult, as an empirical matter, to identify any of these individuals, for example, potential judgment creditors who could have "raced to the courthouse" against a debtor but opted not to on account of preference law. It is highly possible that they do exist and that imposition of an additional penalty on them, and on such creditors as a group, is wholly unnecessary. Additional empirical evidence may be needed to shed further light on the subject.

## VII. CONCLUSION

I have elsewhere argued that the current legal scheme undermines the first of preference goals—equality—and here I have shown how the law, as currently written, is wholly inadequate to serve the second of preference goals—deterrence. This is true even assuming (but not conceding) that deterrence of otherwise legal actions is possible through bankruptcy law, and that deterring the exercise of rights that disadvantage the debtor is desirable.

In order to be an effective deterrent, the law must first target those actors and actions it seeks to discourage. Currently, it targets creditors whether or not they have engaged in behavior worthy of deterrence, imposing costs and nurturing a sense of unfairness and resentment towards the system. Further, the law must impose an actual punishment on targeted creditors if it wishes to deter behavior that, by virtue of being punishable only in bankruptcy, is only marginally likely to create a basis for liability. I have here laid out one proposal for improving preference law's deterrent effect, although I refrain from passing judgment on whether such deterrence is actually desirable from a policy perspective. Such a question is worthy of additional evaluation.