Preferential Transfers in Bankruptcy

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The depressed economic climate caused an upsurge in filings for bankruptcy relief under Ch. 11 U.S.C.A (the "Code"); likewise, preferential transfer litigation necessarily increases as well. There are a myriad of scenarios leading to preferential transfer litigation. Commonly, the debtor settles with his creditors by paying settlement amounts less than what is owed under the original liability; however, some stalwart creditors refuse a settlement and inevitably force the debtor into bankruptcy. The settlement payments may be preferential. Another likely circumstance might include the debtor paying his favorite creditor, his aunt for example, immediately preceding filing for bankruptcy relief to the detriment of a not-so-favorite creditor: Bank of America perhaps. Preferential payments to creditors prior to filing for bankruptcy undermine that goal. Satisfying a debt to your favorite aunt rather than paying Bank of America shows a preference that the Code views as unfair and inequitable. Hence, the drafters of the Code created §547 titled "Preferences." While there are a number of circumstances that may lead to preferential transfers, e.g. recording a judgment lien, this article will focus and discuss the elements constituting a preferential transfer based on a hypothetical cash payment to a creditor.

A fundamental goal of the Code is promoting equality among creditors of the same class. For instance, after dispensing with secured creditors, the claims of the unsecured creditors are paid pro rata from any remaining assets in the bankruptcy estate. Therefore, to understand "preferential transfers" one must first understand the definition of a "transfer."

The initial inquiry resolves whether the transfer of an interest of the debtor in property has occurred. The Code defines a transfer as: the creation of a lien; retaining title as a security interest; foreclosing an equity of redemption; or each mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with property, or an interest in property. The Code defines a transfer very broadly. A transfer can range from the pedestrian: a cash payment from the debtor to the creditor (direct disposition of property), to the intangible: creating a judgment lien for instance.

Once a "transfer" is identified, Section 547 allows the bankruptcy Trustee, or the Debtor-in-possession, to avoid certain transfers of property of the debtor as "preferential". To avoid a transfer as "preferential," the Trustee or Debtor-in-possession must establish that the transfer of the property of the debtor 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) within 90 days of filing the bankruptcy petition, 5) that enables the creditor to receive more than it would have received in a Ch. 7 liquidation but for the transfer.

The first element in the preferential transfer analysis is whether the transfer benefited the creditor. Of course a lump sum payment to a creditor benefits them.

The second element establishes that the transfer of property must relate to an antecedent debt. This element confirms that a preference can only arise in relation to a pre-existing debt, which allows the debtor to conduct its daily business during the preference period without the risk to creditors of losing their payments. For instance, the purchase of a new automobile represented by the exchange of title for money illustrates a contemporaneous exchange for new value rather than payment of an antecedent debt. Payment to Bank of America for several years' worth of credit card debt does not.

The third element of a preference states that the transfer must have occurred while the debtor was insolvent. Congress wrote into the Code that the debtor is presumed insolvent during the 90 days immediately preceding the date of the filing of the petition. The creditor defending against a preference action bears the burden of showing that the debtor was solvent at the time of the transfer unlike proving the remaining elements of a preference, for which the bankruptcy trustee bears the burden.

The fourth element of preferential transfer analysis requires that the transfer occur within 90 days of the debtor filing its petition for relief. In the simplest example, the cash payment occurs when the money changes hands. Therefore, determining when the transfer occurred simply requires a brief analysis of when the payment occurred. However, the analysis gains complexity for the less pedestrian transfer. The Code states that for purpose of preference analysis, the operative time relates to when the transfer was perfected. If the transfer is perfected within 30 days thereof, the Code considers the transfer as occurring when the transfer took effect. If the transfer is perfected outside of 30 days from the time of the transfer, then the time of transfer is the date of perfection. Finally, a transfer is deemed made immediately before the date of filing of the petition if the transfer is not perfected before the commencement of the case.

To illustrate, consider two separate phases in a mortgage transaction; i.e. executing and delivering the mortgage, followed by recording in the public records. One hundred days before the bankruptcy case commences, the debtor executes and delivers a mortgage to the creditor. The creditor then records to secure and perfect its lien 80 days before the debtor commences his case. Because the perfection took place only 20 days after the initial transfer, the Code considers the transfer as occurring on the 100th day, the date of the initial transfer. Thus, the transfer falls outside of the preference period. If there was a delay in recording the mortgage beyond thirty days from its delivery, then the transfer is presumed to take place as of recording. Again, consider the example where the debtor executes and delivers a mortgage 100 days before filing for bankruptcy protection. If the debtor delays recording until 60 days from filing for bankruptcy protection, the Code treats the transfer as occurring on that recording date (in our example, 60 days before filing for bankruptcy protection and well within the preference period). The mortgage could be subject to avoidance. Finally, if the mortgage were never recorded, then the transfer is deemed to occur immediately preceding the commencement of the case. Again, that transaction would be subject to preferential analysis.

The final element of preferential transfer analysis requires showing that by virtue of the transfer, the creditor received more than what it would have received in Ch. 7 liquidation but for the transfer. Referring back to the example of one cash payment to a creditor, assume that the payment satisfied the entire debt. However, in a Ch 7 liquidation, the assets of the estate are paid pro rata to unsecured creditors. Usually each creditor is paid only a small percentage of their entire debt. If the liquidation could only pay 10% of each creditor's claim, then a pre-bankruptcy payment of the entire debt would allow the creditor to receive more than it would have received after the debtor's liquidation. Therefore, the fifth element would be satisfied.

If all of the elements are satisfied, then the transfer may be avoided. The type of transfer dictates the consequences. If the transfer was perfecting a security interest, then the bankruptcy court can adjudge that the property is no longer subject to the lien. If the transfer is a cash payment, the trustee may obtain a judgment against the creditor for that amount. Simply put, you may have to give the money back.