The Problem with Preferences

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In *Conflicting Preferences in Preferences in Business Bankruptcy: The Need for Different Rules in Different Chapters*,[1] Professor Brook Gotberg argues that preference law needs to be simplified and moored tightly to the policy of promoting ratable distribution among unsecured creditors. She further argues that this suggests limiting preference recovery to chapter 7 cases, and "piecemeal" liquidating chapter 11 cases, while at the same time eliminating the "true exceptions" to preference recovery, which she identifies as the ordinary course and new value defenses[2] and the special treatment of statutory liens.[3]

Like Gotberg, I see a problem with preference law and I am sympathetic to the way in which she describes that problem.[4] But I disagree with her about

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1. Brook E. Gotberg, *Conflicting Preferences in Business Bankruptcy: The Need for Different Rules in Different Chapters*, 100 IOWA L. REV. 51 (2014).

2. *Id.* at 72–75 (discussing 11 U.S.C. § 547(c)(2), (4) (2012)).

3. *Id.* at 75 (discussing 11 U.S.C. § 545). Typically, statutory liens attach at, or relate-back to, the time when the lienholder extended value to the debtor. Accordingly, statutory liens are not "preferences" in the technical sense because they are not transfers on account of antecedent debt. They do nevertheless constitute an attempt by States to legislate around the bankruptcy distribution scheme to protect favored types of creditors. *Conflicting Preferences* also identifies as "true exceptions": the de minimis recovery defenses, 11 U.S.C. § 547(c)(8)–(9); the shelter rules that exist for domestic support obligations, 11 U.S.C. § 547(c)(7); and payments made pursuant to approved credit-counseling plans, 11 U.S.C. § 547(h). These additional defenses to preference recovery, whether considered "true" or "narrowing" exceptions, are immaterial in business bankruptcies. On the other hand, *Conflicting Preferences* ignores the most important and least defensible "true exception" of all: the extensive protection afforded to all manner of financial payments and financial contracts by means of the special safe harbors for settlement payments, swap agreements and the like. *See* 11 U.S.C. § 546(e)–(g), (j). *See, e.g.*, Grede v. FCStone, LLC, 746 F.3d 244 (7th Cir. 2014); Official Comm. of Unsecured Creditors of Quebecor World (USA) Inc. v. Am. United Life Ins. Co. (*In re* Quebecor World (USA), Inc.), 719 F.3d 94 (2d Cir. 2013) *cert. denied* 134 S. Ct. 1278 (2014); Enron Creditors Recovery Corp. v. Alfa (*In re* Enron Creditors Recovery Corp.), 651 F.3d 329 (2d Cir. 2011). *Conflicting Preferences* also ignores the privileged position of the holder of an unexercised right of setoff that accrues during the preference period. *See* 11 U.S.C. §§ 506(a), 553.

4. Gotberg, *supra* note 1 at 53–56. As Gotberg notes in conclusion, preference law has long been a favorite topic in the classroom, and among judges and scholars. *Id.* at 92 n.233. The most famous avoidance case of all, *Twyne's Case*, (1601) 76 Eng. Rep. 809 (Star Chamber); 3 Co.

both the source of the problem—failure to single-mindedly frame preference law to advance equality of distribution[5]—and her proposed solutions.[6]

The problem with preference law is that in too many cases it operates, often arbitrarily, to force settlements from diligent creditors based on the cost of litigation and potential liability for basically innocent conduct; settlements that, in the aggregate, do little to meaningfully help creditors generally, but simply enrich estate professionals.

When preference targets are those receiving payments within 90 days of bankruptcy in respect of goods or services, redistributing those preference recoveries to unsecured creditors ratably seems like rearranging the deck chairs on the *Titanic*. Pursuing such creditors for disgorgement of pre-bankruptcy payments in respect of valid trade debts by fighting through a panoply of fact-intensive defenses may provide little benefit to anyone save the lawyers who bill the estate (or successor liquidating trust) for recovering those dollars and then redistributing what is left after payment of administrative expenses to modestly improve general creditor recoveries.[7] This is as true in chapter 7 cases (where the deck chair rearranging is done after the ship has sunk to the bottom of the sea) as it is in chapter 11 cases (where the captain of the ship should be focused on mid-course corrections to avoid the looming iceberg, not deck chairs).

Rep. 80b, though usually discussed as a fraudulent transfer decision, appears to have involved a voidable preference, Robert Charles Clark, *The Duties of the Corporate Debtor to its Creditors*, 90 HARV. L. REV. 505, 513–14 (1977), and in earlier times generations of law students were brought up on such preference classics as *Alderson v. Temple*, (1768) 96 Eng. Rep. 384 (K.B.); 4 Burr. 2234 (Mansfield, L.J.) and *Dean v. Davis*, 242 U.S. 438 (1917). Many distinguished scholars in the bankruptcy field made important contributions to the literature on preferences. *See, e.g.*, THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW 122–50 (1986); Vern Countryman, *The Concept of a Voidable Preference in Bankruptcy*, 38 VAND. L. REV. 713 (1985); Sydney Krause et al., *The Code and the Bankruptcy Act: Three Views on Preference and After-Acquired Property*, 42 N.Y.U. L. REV. 278 (1967); Lawrence Ponoroff, *Evil Intentions and an Irresolute Endorsement for Scientific Rationalism: Bankruptcy Preferences One More Time*, 1993 WIS. L. REV. 1439; Charles Jordan Tabb, *Rethinking Preferences*, 43 S.C. L. REV. 981 (1992); Robert Weisberg, *Commercial Morality, the Merchant Character, and the History of the Voidable Preference*, 39 STAN. L. REV. 3 (1986). The classic treatise in the field is GARRARD GLENN, FRAUDULENT CONVEYANCES AND PREFERENCES (rev. ed. 1940).

5. Gotberg, *supra* note 1 at 81–86. Historically, of course, preference law was fault-based, sharing common roots with the law of fraudulent transfers. But Gotberg is not alone in suggesting that, from a policy perspective, preference law should focus on equitable distribution, while acknowledging that historically equitable distribution has not been the only policy shaping the law. *See, e.g.*, Tabb, *supra* note 4, at 994 ("Equality is fairer and more equitable, it is more efficient, it makes more logical sense, and it is simpler and easier to administer than fault-based theories of preference recovery.").

6. Gotberg, *supra* note 1 at 87–92.

7. Thomas H. Jackson, *Avoiding Powers in Bankruptcy*, 36 STAN. L. REV. 725, 762–63 (1984). *See* Thomas D. Goldberg, *Curbing Abusive Preference Actions: Rethinking Claims on Behalf of Administratively Insolvent Estates*, 23 AM. BANKR. INST. J. 14, 54 (2004) (criticizing non-insider preference litigation that does not materially benefit general creditors). *See also* Gotberg, *supra* note 1, at 56 nn.16–19 (citing authorities).

The extensive statutory safe-harbors for financial creditors only underscore the arbitrariness and unfairness of current preference law.[8] Wall Street has obtained a free pass to demand, accept and retain preferences when it comes to securities settlements, repurchase agreements, options and futures, and indeed apparently any other financial instrument at all that it chooses to label as a "swap agreement."[9] No wonder that, as Gotberg notes, preference law is unpopular within the general business community.[10]

The proper way to address this problem, however, is not to increase the exposure of trade creditors to petty preference recovery by eliminating the ordinary course, new value and de minimis recovery defenses. These defenses ameliorate, albeit imperfectly, the very unfairness academics (including Gotberg) and businesspersons complain of. The simplest solution to this unfairness would be to raise the jurisdictional limit on preference recovery from $6,225 to $100,000 or more,[11] or to protect payments in respect of debts for all goods or services delivered to the debtor within 90 days of filing, regardless of the chapter under which the debtor files for bankruptcy relief.[12]

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8. *See* Stephen J. Lubben, *The Bankruptcy Code Without Safe Harbors*, 84 AM. BANKR. L.J. 123, 124 (2010); Charles W. Mooney, Jr., *The Bankruptcy Code's Safe Harbors for Settlement Payments and Securities Contracts: When is Safe* Too *Safe?* 49 TEX. INT'L L.J. 245 (2014); Mark J. Roe, *The Derivatives Market's Payment Priorities as Financial Crisis Accelerator*, 63 STAN. L. REV. 539, 573 (2011).

9. 11 U.S.C. §§ 101(53B) ("swap agreement"), 546(e)–(g), (j) (2013). *See* Hutson v. E.I. du Pont de Nemours & Co. (*In re* National Gas Distributors, LLC), 556 F.3d 247, 259 (4th Cir. 2009) (noting that "[w]ith the 2005 Amendments to the Bankruptcy Code, . . . Congress substantially expanded the protections it had given to financial derivatives participants and transactions by expanding the definition of 'swap participants' and 'swap agreements' that are exempted from the automatic stay and from trustees' avoidance powers").

10. Gotberg, *supra* note 1, at 53–56.

11. Preference suits are often viewed as extortion by trade creditor defendants because the costs of defense, often in a remote forum, can easily exceed the stakes. *See* Goldberg, *supra* note 7; Deborah L. Thorne & John T. Gregg, *A Partial Solution to "Preference Litigation Run Amok,"* 26 AM. BANKR. INST. J. 22 (2007). Raising the jurisdictional limit would also have added logistical benefits and should significantly reduce estate professionals' preference analysis expenses in the larger cases. Gotberg, *supra* note 1, at 55 n.15.

12. This latter approach hearkens back to the pre-Code judicial net result rule of *Kaufman v. Tredway*, 195 U.S. 271 (1904) and *Jaquith v. Alden*, 189 U.S. 78 (1903), which recognized a preferred creditor's right to setoff preferences received with advances made during the preference period to determine whether a net preference exists on a running account. *See* KENNETH N. KLEE, BANKRUPTCY AND THE SUPREME COURT 343–45 (2008) (discussing the net result rule and its subsequent rejection in the Bankruptcy Reform Act of 1978). It is also consistent with (indeed, could be viewed as the culmination of) recent developments including the growth of critical vendor orders, *In re* Kmart Corp., 359 F.3d 866 (7th Cir. 2004), the expansion of the ordinary course of business defense, Hutson v. Branch Banking & Trust Co. (*In re* Nat'l Gas Distribs., LLC), 346 B.R. 394 (Bankr. E.D.N.C. 2006), expansion of reclamation rights, *In re* Dana Corp., 367 B.R. 409 (Bankr. S.D.N.Y. 2007), and the creation of an administrative priority for vendor claims based on eve-of-bankruptcy shipments of goods. 11 U.S.C. § 503(b)(9). *See also* Richard Levin & Alesia Ranney-Marinelli, *The Creeping Repeal of Chapter 11: The Significant Business Provisions of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005*, 79 AM. BANKR. L.J. 603, 604–08 (2005).

Conflicting Preferences suggests a different path, making preference recovery unavailable in chapter 11 but radically reducing the putative defendants' defenses to recovery in chapter 7. In justifying her proposal, Gotberg unduly emphasizes the policy of ratable distribution regardless of fault as the foundation for preference law.[13] Certainly, the legislative history of the 1978 Code suggests this policy is an important goal of preference law. Congress expressly relied on this policy to justify eliminating the traditional subjective element of the trustee's case-in-chief.[14] But the 1978 Code and its legislative history also clearly indicate that equality of distribution must be balanced against other objectives.[15] The interest in ratable distribution alone is insufficient to warrant avoidance in at least some situations involving innocent transferees. By tying preference law exclusively to the goal of equality of distribution, *Conflicting Preferences* ignores the necessary and important role traditional preference law plays in controlling express opt-out behavior by in-the-know creditors, especially insider-creditors, who, accurately anticipating bankruptcy, 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

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13. Gotberg, *supra* note 1, at 56–60, 81–87.

14. Under the Bankruptcy Act of 1898, ch. 541, 30 Stat. 544 (repealed 1978), the trustee had to establish that the defendant had reasonable cause to believe the debtor was insolvent at the time the defendant received the preference to recover the preference. *See* 11 U.S.C. § 96b (1976) (repealed 1978); Coder v. Arts, 213 U.S. 223, 239–40 (1909). Obviously under this framework, the policy of equality of distribution was generally deemed insufficient to impose liability on a wholly innocent preference recipient. The pre-1978 scheme suggests that controlling opt-out behavior rather than equality of distribution was the central policy of preference law. Although the 1978 Code eliminated the "reasonable cause to believe insolvent" element of the trustee's case-in-chief, thereby emphasizing equality of distribution, it is evident that the 1978 Code's key statutory defenses (ordinary course and new value), labeled by Gotberg as "true exceptions," Gotberg, *supra* note 1, at 67, further policies supporting the maintenance and finality of settled commercial transactions that Congress felt still outweighed the interest in ratable distribution, at least in the case of innocent transferees and in some contexts. Union Bank v. Wolas, 502 U.S. 151, 160–62 (1991). A House Committee report summarized:

> [t]he purpose of the preference section [of the 1978 Code] is two-fold. First . . . creditors are discouraged from racing to the courthouse to dismember the debtor during his slide into bankruptcy. The protection thus afforded the debtor often enables him to work his way out of a difficult financial situation through cooperation with all of his creditors. Second, and more important, the preference provisions facilitate the prime bankruptcy policy of equality of distribution among creditors of the debtor.

H.R. REP. NO. 95-595, at 177–78 (1977). The Court further noted that these "policies are not entirely independent." *Union Bank*, 503 U.S. at 161. For a fuller discussion of opt-out behavior and preference law. *See* Jackson, *supra* note 7, at 759–63.

15. *See, e.g.*, H.R. REP. NO. 95-595 at 373 (describing the purpose of the ordinary course of business exception as "leav[ing] undisturbed normal financial relations, because it does not detract from the general policy of the preference section to discourage unusual action by either the debtor or his creditors during the debtor's slide into bankruptcy").

on the eve of bankruptcy.[16]

Despite Gotberg's protestations to the contrary, preference law has always emphasized controlling this opt-out behavior over forced disgorgement of innocently received preferences. 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. Repealing preference law in chapter 11 will remove a significant disincentive to such opt-out behavior where it is most socially destructive (*i.e.* where there is a potentially viable business to reorganize) and make remediation of that behavior impossible while pursuing reorganization. By tying preference recovery to liquidation, *Conflicting Preferences* makes forced liquidation a precondition for unwinding destructive prepetition opt-out behavior. Preference law seeks to control opt-out behavior precisely because it threatens to destroy the possibility of reorganizing an otherwise viable business; under the *Conflicting Preferences* approach, liquidation—the least desired result—becomes the only means of recovering the preference.[17]

Moreover, if the rule is that preferences can only be avoided in chapter 7, then the existence of significant preferences will torpedo some viable reorganizations even if most creditors prefer a feasible reorganization presently in prospect to recovery of the preference. Chapter 11 plan confirmation requires a judicial finding that each dissenting creditor receive at least as much under the plan as it would in a hypothetical chapter 7 liquidation.[18] If large

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16. *Id. See also Union Bank*, 502 U.S. at 162 (noting "the availability of the ordinary business exception to long-term creditors does not directly further the policy of equal treatment" but going on to say "it does further the policy of deterring the race to the courthouse and, as the House Report [95-595] recognized, may indirectly further the goal of equal distribution as well"); Countryman, *supra* note 4, at 772–75; Jackson, *supra* note 7 .

17. *See* Douglas G. Baird, *A World Without Bankruptcy,* 50 LAW & CONTEMP. PROBS. 173, 183 (1987) ("Without a collective bankruptcy proceeding, each creditor will tend to rush towards the debtor's assets when the best course is patience."); Elizabeth Warren, *Bankruptcy Policymaking in an Imperfect World,* 92 MICH. L. REV. 336, 350–52 (1993) (using preference law as an example of a feature of the bankruptcy system designed to deter creditors from inefficiently exercising nonbankruptcy remedies against insolvent firms, thereby enhancing the overall "value of the failing company by reducing creditors' incentives to dismantle it"). Gotberg suggests that there are other means of policing such opt-out behavior than the law of preferences, citing fraudulent transfer law. Gotberg, *supra* note 1, at 80 n.168, 85 n.199, 89 n.217. But distributions on account of antecedent debt, whether or not preferential, are for "value" under fraudulent transfer statutes, *see, e.g.*, 11 U.S.C. § 548(d)(2)(A), and therefore generally not subject to avoidance as fraudulent transfers. Preference law evolved precisely because fraudulent transfer law as traditionally formulated was inadequate to control preferential transfers. Similarly relying on disuniform and undeveloped state law for insider preference recovery under Uniform Fraudulent Transfer Act § 5(b) (or its recently promulgated successor, NCCUSL's Uniform Avoidable Transfer Act) and analogues in chapter 11 would only seem to sow confusion and uncertainty without any apparent corresponding benefit over current application of section 547 of the 1978 Code in chapter 11 cases. *Compare* Gotberg, *supra* note 1, at 89 & n.217.

18. 11 U.S.C. § 1129(a)(7)(A)(ii) (2012).

preferences can only be recovered in chapter 7, then this finding cannot be made, even if all impaired classes consent to the plan. Indeed, as Gotberg notes, even modest preferences could render a liquidating chapter 11 plan impossible to confirm unless similar preference recovery were available in liquidating chapter 11 cases.[19]

In sum, blanket repeal of preference law in chapter 11, while enhancing preference recovery in chapter 7, insulates, indeed rewards, affirmative opt-out behavior by insiders and creditors with superior knowledge or leverage to successfully obtain property or perfect liens in anticipation of bankruptcy, while undermining the reorganization objectives of chapter 11. It will encourage, and in some instances require, liquidations that would not otherwise be necessary or desirable. *Conflicting Preferences* does not offer a promising route for reform in the context of reorganizing companies.

Nor would Gotberg's proposal have beneficial effects in the liquidation context. The abuse of preference law Gotberg is concerned about will remain. Trustees chasing preferences in chapter 7 cases who are engaged in rearranging deck chairs at significant administrative cost will not be deterred by Gotberg's proposed reform. Indeed, by repealing the existing defenses that (admittedly, only partially) ameliorate the trustee's current leverage to extract settlements, the reform proposed in *Conflicting Preferences* would actually aggravate the problem with preferences. All the while the proposal leaves counterparties to qualifying financial contracts untouched, notwithstanding the supposed overriding policy of equality of distribution regardless of fault.

In the marginal reorganization cases, Gotberg's proposal would have its most deleterious effects. Putative preference defendants in current marginal chapter 11 cases would be doubly worse off under the *Conflicting Preferences* proposal. That proposal requires or incentivizes conversion to chapter 7 where those defendants will be more vulnerable to preference attack with reduced legal defenses. In chapter 7, those putative defendants, along with the rest of the creditor body, would also forfeit any going concern value that could be realized through reorganization, and incur hefty costs defending and settling preference suits. This seems an undue price to pay merely for the pleasure of forcing putative preference defendants, many of whom have done nothing wrong, to disgorge and thereby be placed in the same state of misery as general creditors who did not receive preferences.[20]

Gotberg does a great service by correctly and lucidly identifying the problem with preference law as currently configured. But she errs in diagnosing the cause and prescribing the treatment.

19. Gotberg, *supra* note 1, at 86–87.

20. *See In re* Tribune Co., 464 B.R. 126, 134–35 (Bankr. D. Del. 2011) (reciting the parable of *The Scorpion and the Fox* which concludes with the Scorpion's reply "better we should both perish rather than my enemy should live").

As to cause, preference law is not and should not be a single-minded pursuit of equality of distribution without consideration of complementary, and even countervailing policies. To the contrary, the recent arc of preference law is (as noted above) strongly driven by refocusing on culpable opt-out behavior, and the goal of ratable distribution has been sharply subordinated to other objectives.

As for Gotberg's reforms, they are counterproductive. Raising (not abandoning) the floor on preference recovery, bolstering (not eliminating) trade creditors' ordinary course and new value defenses to recovery of otherwise preferential payments, and limiting or eliminating the safe harbors for financial contracts, all without discriminating between Code chapters, would reduce arbitrariness and unfairness in the application of preference law. Moreover, these alternatives would enable preference law to continue to fulfill its traditional function of policing the most extreme forms of opt-out behavior, and fostering reorganizations where such reorganizations remain viable and desirable notwithstanding eve-of-bankruptcy opt-out actions by creditors and insiders.