**Title:** THE BANKRUPTCY PRIMER: What is a Preferential Transfer?

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**Date:** 0-2-2012

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**Formatted Content:**

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<h3 style="text-align: left;">What Is A Preferential Transfer?</h3>
Bankruptcy is a strange area of law -- filled with arcane language and incomprehensible legal concepts. Consider, for example, the bankruptcy judge’s responsibility in “cramming down” secured claims to determine whether the secured creditor has realized “the indubitable equivalent” of its claim. Bankruptcy cases also involve more personal pain than any other area of law, save divorce proceedings. It is not just the pain experienced by the bankrupt and its associates. The creditors all too frequently find the process painful as well. Indeed, bankruptcy has frequently been described as a method of allocating financial pain in the most equitable manner possible. Nevertheless, in all of the strangeness and discomfort of bankruptcy, there is nothing more troubling to business people then the matter of the preferential transfer. This article, and those to follow, will attempt to explain preferential transfers to you.
What is a “preference”? The classic definition of a preferential transfer comes from the Bankruptcy Code itself. Section 547 of the Bankruptcy Code defines a preferential transfer as (1) any transfer of property, (2) by an indebted person, (3) to a creditor, (4) for an old debt, and (5) made within the 90 days before bankruptcy.  Section 547 then requires that all such “preferences” be returned to the debtor.
Here is how the process works in the “real life” of a business bankruptcy case. At some point after the bankruptcy, an examination will be made of the bankrupt’s bank accounts.  The examination will identify all payments the bankrupt made to its creditors within the 90 days before the bankruptcy case was filed. All persons who received such payments will then get a letter demanding that the payments be returned. Outrage will ensue, followed by angry phone calls to the attorneys sending such letters. All of this will be to no avail, and lawsuits will shortly be brought in bankruptcy court against the creditors, to recover the allegedly wrongful preferential transfers.
<h3>A Brief History Lesson</h3>
Some historical background is helpful. Since the United States Bankruptcy Act of 1841, it has been recognized that the courts could seize payments made to creditors in contemplation of bankruptcy. In fact, the concept goes back to 16<sup>th</sup> centuryBritain, where Parliament outlawed transfers of property by a debtor made with the effect hindering, delaying or defrauding its creditors. In those days, the punishment consisted of imprisonment and the forfeiture of real property, in addition to seizure of the wrongful payment. While some more activist American bankruptcy judges are known to favor the rack and thumb screw, most seem content with simply seizing preferential transfers.
The federal commission that drafted the current Bankruptcy Code noted in its official comments that preferential transfer liability has three goals: (1) to lessen the possibility of a scramble among creditors for advantage as their debtor slides into insolvency, (2) to promote equality among classes of creditors in what they get out of the debtor’s assets, and (3) to eliminate the incentive to make unwise loans in order to obtain a preferential payment. Thus, from the standpoint of fundamental fairness, it makes sense to keep particular creditors from taking advantage of special relationships they might have with the debtor in order to obtain payment just before a bankruptcy filing, particularly, when other creditors do not the same advantage.
As a factual matter however, these fine public policy points are of cold comfort to a creditor who has exercised diligence and thereby managed to squeeze a last payment or two out of a faltering customer just before it files bankruptcy. Typically, these last “squeezed” payments never make the creditor whole anyway, so the loss is compounded when the creditor then gets the cheery letter from the debtor demanding that the squeezed payments be returned.
In future postings, we will consider the legal requirements of preferential transfers, the possible defenses available, and the proper planning tools a creditor may use if it begins to suspect that a customer is slipping into insolvency.