What Is a Preferential Transfer?

A preferential transfer occurs when a debtor, prior to filing for Chapter 7 bankruptcy, pays off a particular creditor or group of creditors and by doing so, causes other creditors to get less in the bankruptcy. For example, a debtor may wish to repay a debt to a friend or family member, to make sure that person gets paid in full (and shield the money used to repay the debt, which would instead be divided among all of the debtor's creditors). Or, a debtor may wish to repay a debt to a local doctor or other professional with whom the debtor has an ongoing relationship, to make sure the debtor can keep using that person's services.

Only transfers made within a certain amount of time before the filing of the bankruptcy count as preferences. The rules depend on your relationship to the creditor:

- During the year before you file for bankruptcy, any payment of more than $600 to an "insider" creditor -- typically, a friend, family member, or business associate -- counts as a preference, subject to the clawback.
- During the 90-day days before you file, any aggregate payment of more than $600 to a regular creditor (someone other than an insider).

The problem with preferential transfers (also called preferences) is that it benefits one creditor at the expense of the rest. Rather than having their debts tossed into the bankruptcy hopper and receiving pennies on the dollar from the bankruptcy trustee (if that), creditors who receive preference payments are paid in full (which leaves that much less money to be distributed to other creditors).

Watch Out for the Clawback

When a trustee becomes aware of a pre-bankruptcy transaction that counts as a preferential transfer, the trustee can petition the court to have those assets retrieved (the clawback) and included in the bankruptcy estate. Then, those extra funds can be used to benefit all of the creditors, not just one or two whom the debtor selected.