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PREFERENCE CONUNDRUMS

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Every law teacher and many law students and practitioners understand the intellectual sport to be found in Section 547 on preference law. Because the preference rules are so intricate, rigorously logical—but really not logical—they command more than their fair attention, not only in law school but also in continuing legal education and even in the courts. Our purpose in this article is not to answer any of the difficult questions or to give a global explanation of preference law. Rather it is to confront a few of the conundrums in Section 547 and to follow the paths of those conundrums a little farther into the bush than have others.

We concentrate on four preference problems. The first is the application of 547(c)(5), the exception for after-acquired property. Second, we examine the vitality of the old arguments that were used where 547(c)(5) is now used. Surprisingly some parts of those have survived the enactment of the 1978 Code. Next we deal with the question when is the hypothetical date of liquidation under (b)(5) and we conclude with a first cousin of the *Deprizio* issue—the issues arising when a payment to one creditor arguably causes a preference to another. Those interested in answers should not look here. This is for those interested in playing in the complexities of preference law.

I. AFTER-ACQUIRED PROPERTY CONUNDRUM

Security interests in inventory and receivables are often referred to as the creditor's "floating lien" (the metaphor "floating lien" because the security floats upon and covers a shifting quantity and quality of property sometimes described as a "moving stream"). New goods may be substituted for old goods. Goods may change as they are processed or manufactured into different goods. These, in turn, may be converted into rights to payment, receivables. Because the debtor's inventory and re-

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ceivables relating to a particular security interest constantly change, the creditor's interest must "float" over the inventory and receivables.

Under the Bankruptcy Act of 1898 substantial controversy surrounded the floating lien.¹ Since an Article 9 security interest cannot attach or be perfected until the debtor acquired "rights in the collateral,"² trustees under the Act argued that the transfer of the security interest in inventory or receivables could not occur until specific items of inventory or particular accounts were acquired or generated by the business. Thus, security interests in inventory or accounts acquired or generated by the debtor during the preference period³ could not be transferred until each individual item or account came into the debtor's hands. Since the transfer would usually be after the creditor had given value and while the debtor was insolvent, the trustee in bankruptcy could set aside the secured creditor's interest in inventory and receivables acquired during the preference period—so said the trustee.

The courts did not agree. In *DuBay v. Williams*⁴ the court gave complete effect to the creditor's after-acquired property clause. The court determined that "perfection" for bankruptcy purposes could occur before attachment under Article 9. It stated that the transfer of the security interest to the secured creditor was deemed to have occurred when the creditor filed its financing statement, a time that might long precede the preference period.⁵ Following cases such as *DuBay*, courts routinely allowed all security interests in inventory and receivables to escape the reach of the trustee in bankruptcy.⁶

Section 547(c)(5) is the 1978 Code response to *DuBay et al.* One of the six limitations to 547(b), Section 547(c)(5) exempts certain transfers of after-acquired property from avoidance.

To see the need for 547(c)(5), one must first understand how a "floating lien" security interest would be handled under 547(b). Assume an owner of a swim shop who ninety days before bankruptcy owes the secured party \$10,000 under a loan secured by the debtor's present and after-acquired inventory and receivables. On this day, the secured party has a perfected security interest in debtor's \$4,000 inventory of swimsuits and goggles. Eighty days later when the debtor files a Chapter 7 petition, the stock of inventory has completely turned over and the \$10,000 loan is now secured under the after-acquired property clause by

1. Report of the Commission on the Bankruptcy Laws of the United States, reprinted in 2 *Collier on Bankruptcy* 203 (15th Ed. 1979).

2. U.C.C. §§9-203, 9-303.

3. The four months preceding a bankruptcy filing under Section 60; 90 days (one year for insider cases) under Section 547.

4. 417 F.2d 1277 (9th Cir. 1969).

5. 1A. Coogan, Hogan, Vagts & McDonnell, *Secured Transactions Under the U.C.C.* § 7.04[2][B], 7-28 (1991).

6. *Grain Merchants of Indiana v. Union Bank & Sav. Co., Bellevue, Ohio*, 408 F.2d 209 (7th Cir. 1969); *In re Nason*, 13 B.R. 984 (Bankr. D.R.I. 1981); *Cissell v. First Nat. Bank of Cincinnati*, 471 F.Supp. 484 (S.D. Ohio 1976).

\$8,000 worth of swim caps and kick boards.

Under 547(b) the trustee would claim a preference of \$8,000. The trustee must show that: (1) there was a transfer of property of the debtor, (2) to or for the benefit of the creditor, (3) on account of an antecedent debt, (4) made within ninety days of bankruptcy, (5) while the debtor was insolvent, and (6) with the effect of giving the creditor a greater return on his debt than he would have received had the transfer not occurred and the creditor received his recovery solely under the liquidation provisions of the Code.

In this example the secured party has received an \$8,000 dollar preferential transfer of a perfected security interest in the swim caps and kick boards. Because of 547(e)(3) of the Code the inventory is not deemed transferred "until the debtor acquires rights in the collateral"; in the example, all \$8,000 of inventory was "transferred" during the ninety-day preference period (so much for *DuBay*). It was on account of an antecedent debt (the preexisting \$10,000 loan), and was made while the debtor was presumed to be insolvent under Section 547(f).⁷ This same analysis would apply for any case involving a floating lien. Section 547(e)(3)⁸ embraces and codifies the argument that was made unsuccessfully by trustees before the Code, and overturns the basic holding in *DuBay v. Williams*.⁹ Without 547(c) most security interests in after-acquired property acquired within the preference period will be considered transfers on account of an antecedent debt, and would be avoidable by the trustee. Because the floating lien was such a common, efficient and important form of security, the drafters of the Bankruptcy Reform Act dared not allow it to be routinely destroyed as a preference.

But the drafters were confronted by directly conflicting arguments. On one hand was the rationale of cases such as *DuBay* which said that no floating liens were preferential. On the other was the trustee's old claim that all security interests attaching to property acquired within the preference period should be preferential. Chaired by Professor Grant Gilmore, the drafting committee reached a compromise.¹⁰ This compromise is a "safe harbor" from 547(b) for security interests in receivables, inventory and their proceeds, Section 547(c)(5). The rule in (c)(5) is often referred to as the "improvement in position test";¹¹ it is applied by comparing the creditor's status at two points. A creditor with a security in-

7. See, generally, Duncan, *Preferential Transfers, the Floating Lien, and Section 547(c)(5) of the Bankruptcy Reform Act*, 36 ARK. L. REV. 18, 24 (1982-1983).

8. 11 U.S.C. 547(e)(3): For the purposes of this section, a transfer is not made until the debtor has acquired rights in the property transferred.

9. 417 F.2d 1277 (9th Cir. 1969).

10. Report of the Committee on the Coordination of the Bankruptcy Reform Act and the Uniform Commercial Code (1970), reprinted in 1978 U.S. Code Cong. & Ad. News, 6164-6179.

11. Report of the Committee on the Judiciary, United States Senate, S. Rep. No. 95-989, 95th Cong. 1st Sess. (1978), reprinted in 3 *Collier on Bankruptcy* 88 (15th Ed. 1979).

terest in inventory and receivables is subject to a preference attack to the extent he improves his position within ninety days of bankruptcy. To measure the improvement one compares the secured party's position ninety days before the filing of the petition (point 1) and the date of the petition (point 2).¹² A simplistic way to apply this test compares the difference between the debt and the value of the collateral ninety days before bankruptcy with the difference at the date of bankruptcy. If the former is greater than the latter, any transfers that caused a reduction in this difference (between the debt and the value of the collateral) are preferences not saved by (c)(5).

It is important to remember, however, that 547(c)(5) applies only to a creditor who is undersecured ninety days before bankruptcy. The creditor who is fully secured cannot be attacked under 547(b). There is no initial deficiency and later transactions cannot improve the creditor's position.

The commission described the (c)(5) compromise as follows:

Although there are drawbacks to the "improvement in position" exception, it seems an appropriate compromise. It avoids the vice of the *DuBay* decision, which seemingly protects from preference attack any payment or securing pursuant to an after-acquired property clause. And it does not impose an inordinate burden on legitimate financing transactions, since the burden of proof is expressly placed on the trustee to establish an improvement in position by an increase in the value of the security at the expense of the estate and the extent thereof.¹³

Let us start with a simple illustration: Suppose that ninety days before bankruptcy the debtor, owner of a jewelry store, owed the secured party \$5,000,000 under an earlier perfected security agreement in the debtor's present and future inventory. On this date (ninety days before bankruptcy) the inventory had a value of \$3,000,000. Before the date of bankruptcy the debtor sold all of his inventory and acquired \$4,000,000 of new inventory. One would apply the 547(c)(5) two point improvement in position test as follows. There has been a \$4,000,000 transfer of inventory that would be voidable under (b). But the difference between the debt and the collateral has been reduced from \$2,000,000 ninety days before bankruptcy (\$5,000,000-\$3,000,000) to \$1,000,000 at the date of bankruptcy (\$5,000,000-\$4,000,000). Thus (c)(5) saves \$3,000,000 and leaves a preference of only \$1,000,000.

To begin to see the uncertainties, consider a variation: The debtor

12. Report of the Committee on the Judiciary, House of Representatives, H.R. Rep. No. 95-595, 95th Cong. 1st Sess. (1977), reprinted in 2 *Collier on Bankruptcy* 374 (15th Ed. 1979). Note that if new value was first given within 90 days of bankruptcy, the date on which the new value was given substitutes for the 90-day point. See *Lackow Brothers Inc. v. Roelmeyer (Matter of Lackow Bros., Inc.)*, 752 F.2d 1529, 1532 (11th Cir. 1985).

13. Report of the Commission of the Bankruptcy Laws of the United States, Pt. II H.R. Doc.No. 137, 93rd Cong., 1st Sess. (1973), reprinted in 2 *Collier on Bankruptcy* 167 (15th Ed. 1979).

owed the secured party \$2,000,000 under a preexisting loan secured by debtor's present and after-acquired "inventory and receivables." Ninety days prior to bankruptcy the secured party had a perfected security interest in \$1,500,000 of debtor's inventory. Forty-five days before bankruptcy the debtor makes a payment to the secured party of \$200,000. Meanwhile, the debtor's inventory has turned over completely and stands at \$1,500,000. On the date of filing the petition, the debt is \$1,800,000 secured by debtor's inventory of \$1,500,000.

Section 547(b) calls for a preference of at least \$1,500,000.¹⁴ A mechanical application of the two point test in this case saves \$1,300,000 of this amount and leads to the conclusion that the secured party has received a preference of \$200,000. But the transfer that caused a reduction in the gap between the value of the collateral and the debt of \$2,000,000 ninety days before bankruptcy (\$2,000,000-\$1,500,000), on the date of bankruptcy (\$1,800,000-\$1,500,000) was the \$200,000 payment, not so?

Careful reading shows that preferential *payments* are never saved by (c)(5); it reads:

the trustee may not avoid under this section a transfer-
(5) of a *perfected security interest* . . . to the extent that the aggregate of all *such transfers to the transferee* caused a reduction.

Clearly the only transfers protected by (c)(5) are transfers of "a perfected security interest." But are only transfers of security interests examined when one is determining improvement in position by which the creditor has benefited? In one sense the \$1,500,000 of new inventory acquired by the debtor in our example did "cause" a reduction in the difference between the debt and the collateral at the time the inventory was acquired (\$0 inventory to \$1,500,000). However, the two point test looks at the debt and collateral at two dates, ninety days before bankruptcy and the date of bankruptcy. Under this test the acquisition of \$1,500,000 inventory did not "cause" a reduction (ninety days \$1,500,000, date of petition, \$1,500,000). If one ignores the payment, there is no voidable preference arising from the after-acquired property because (c)(5) saves the transfer. That is true despite the improved position.

The legislative history and other commentaries¹⁵ on 547(c)(5) generally agree that only transfers of interest in collateral are saved. The Commission report on the Bankruptcy Laws of the United States states:

. . . the perfected security interest is not avoidable except to the extent that the transferee has improved his position by an increase in the value of the security at the expense of the estate.¹⁶

14. If the \$200,000 payment is not somehow saved by 547(c), it too will be preferential.

15. See Nimmer, *Security Interests in Bankruptcy: An Overview of Section 547 of the Code*, 17 HOUS. L.REV. 289 (1980).

16. *Supra* note 13 at 210.

This language and the language of the statute disregard payments made to the creditor by the debtor because they are not transfers of security made at the expense of the estate. In the words of Professor Nimmer, "Despite its elegant simplicity, Section 547(c)(5) requires that the reduced deficiency be 'caused' by transfers of security."¹⁷

Here is the logic of this position. If a payment were allowed to be used in calculating the reduction in the gap of collateral versus debt under (c)(5), the creditor would be exposed to double liability with respect to the payment.¹⁸ First, the payment itself could be directly attacked as a \$200,000 transfer without regard to (c)(5). If it is taken into account a second time—in calculating the "improved position" under section 547(c)(5)—the payment of \$200,000 would produce a total preference of \$400,000.¹⁹ The payment made by the debtor to the creditor should be treated separately and analyzed under 547(b) along with the exceptions under 547(c).²⁰

Consider a second example. Ninety days before bankruptcy the debtor owes the creditor \$2,000,000 and the loan is secured by \$1,000,000 of inventory. Eighty days before bankruptcy the creditor lends the debtor an additional \$1,000,000. Subsequently, but before bankruptcy, the collateral has completely turned over and the inventory has a value of \$1,500,000 on the date of bankruptcy.

A mechanical application of the net improvement test would lead us to the following result. Ninety days before bankruptcy the difference between the debt and the value of the collateral was \$1,000,000 (\$2,000,000-\$1,000,000) and on the date of the bankruptcy the difference between the debt and the value of the collateral was \$1,500,000 (\$3,000,000-\$1,500,000). Since the gap between the debt and the collateral has widened, there is no improvement to the creditor; arguably, therefore, the creditor is completely protected by the 547(c)(5) exception.

But that conclusion is inconsistent with our analysis in example Number 1. In our first example, we argued that one should not include payments in calculating the debt at the date of bankruptcy. Yet in our mechanical application of the formula to Number 2, we have included a

17. Nimmer, *supra* note 15 at 321.

18. See Duncan, *Preferential Transfers, the Floating Lien, and Section 547(c)(5) of the Bankruptcy Reform Act*, 36 ARK.L.REV. 18, 27 (1982-1983).

19. This would be the case unless the payment was somehow saved by another exception under 547(c).

In our hypothetical above, the analysis would be as follows: 90 days before bankruptcy the difference between the debt and the value of the collateral was \$500,000 (\$2,000,000-\$1,500,000), and on the date of the petition the difference between the debt (disregarding any payments) and the value of the collateral would still be \$500,000 (\$2,000,000-\$1,500,000).

20. If the trustee can show that the \$200,000 payment meets all the requirements of 547(b) and is not saved by one of the exceptions of 547(c) then it would be a preference. In this example the \$200,000 would not be avoidable by the trustee if it were an "ordinary course payment," 547(c)(2). 11 U.S.C. 547(c)(2) (Supp.IV 1980).

payment going the other way (the new loan by the creditor to the debtor). There is no reason here to treat variations upward in the debt (new extensions of credit) any differently than one would treat variations downward (payments by the debtor to the creditor). Just as the payments should be treated separately under 547(b) and under other exceptions in 547(c), so should new advances.

Under hypothetical number 2 the amount of the preference not saved by (c)(5) arising from the transfer of after-acquired assets would be \$500,000. Ninety days before bankruptcy the gap between the debt and the collateral was \$1,000,000 (\$2,000,000-\$1,000,000), at the date of bankruptcy and disregarding the new advance of \$1,000,000, there is a gap of \$500,000 (\$2,000,000-\$1,500,000). The inventory build up may have injured other creditors. Whether the new loan will insulate other transfers to the creditor depends on 547(c)(4).²¹

Necessarily, we reject some other interpretations of the improvement in the position test under 547(c)(5). Does an "improvement in position" occur when and only when the percentage of the creditor's debt secured at the time of the petition exceeds the percentage secured ninety days before bankruptcy?²² We do not think so. Applying this analysis to hypothetical number 2 leads to the following result: At ninety days before bankruptcy the creditor was 50 percent secured (\$2,000,000 debt and \$1,000,000 of collateral) and on the date of the petition the creditor was 50 percent secured (\$3,000,000 of debt and \$1,500,000 of collateral). Using only a percentage test there would be no preference. This test does not discriminate between changes caused by advances or payments and those caused by after-acquired property.

To add to the mischief, consider a small twist on our earlier case. Ninety days before bankruptcy, debtor owed the secured creditor \$2,000,000 under a preexisting loan secured by present and after-acquired inventory. On this date the secured party has a perfected security interest in debtor's \$1,500,000 worth of inventory. Fifty days prior to bankruptcy the debtor made a \$500,000 cash payment to the secured party, and by forty-five days before bankruptcy the inventory turns over and grows to \$2,000,000, where it stands on the date of bankruptcy. What part of the \$2,000,000 is saved by 547(c)(5)?

21. Another way to look at the problem is to regard the transfers of security interest and all other transfers as completely separate transactions. Assume that the \$1,000,000 in new advances came not from the original secured creditor but from secured party 2, and assume that the debtor gave secured creditor 2 a security interest in after-acquired inventory not covered by secured party 1's security interest. If, at the time of bankruptcy but subsequent to the loan, the debtor had acquired \$500,000 worth of inventory subject to secured party 2's security agreement, there would be a \$500,000 voidable preference. Because new value was given for the first time within the 90-day period, 547(c)(5)(B) would apply, and the date the new value was given would act as the first point on the two point test, creating an initial gap between the debt and collateral of \$1,000,000 (\$1,000,000-\$0) and at the date of the petition the gap would be \$500,000 (\$1,000,000-\$500,000).

22. Barkley Clark seems to suggest so in *Preferences Under the Old and New Bankruptcy Acts*, 12 UCC L.J. 154, 178 (1979-1980).

Assume for the moment that a gap cannot be "reduced" below zero. Increasing the value of the collateral *above* the amount of debt does not injure other creditors. True? Ninety days before bankruptcy the debt was \$2,000,000 and the collateral was worth \$1,500,000; at the date of the petition, the debt was \$2,000,000 (disregarding payments) and the collateral was \$2,000,000. Disregarding all payments, the gap here has been reduced by \$500,000, an improved position for the creditor that would allow the trustee to avoid the entire \$500,000 under 547(b) and (c)(5).

But if one considers the payment as independent of the after-acquired property transfer, he finds two preferences: one for the payment of \$500,000 and one attributable to the after-acquired property of \$500,000.²³ This must be wrong. A creditor with a \$500,000 unsecured claim (the creditor's position ninety days before bankruptcy) should not be able to experience more than a \$500,000 preference. If one follows our advice and considers the payments separately from the after-acquired property, how does he find only a \$500,000 preference? We are not certain; perhaps only by a careful reading of the sixth requirement, 547(b)(5) (that enables the "creditor to receive more than [he] would receive" on liquidation).

II. VITALITY OF OLD ANSWERS UNDER 547(c)(5)

Prior to 1978 secured creditors with interests in after-acquired collateral sometimes defended against preference attacks by arguing that new value had been given in the form of a release of old collateral in return for the transfer of newly acquired collateral. Thus, for example, a debtor might sell five automobiles and procure five replacement automobiles. In such circumstances the creditor could argue that it had given new value for its security interest in the after-acquired automobiles by permitting the creditor to sell the old automobiles free of its security interest. If these transactions were contemporaneous, there would be no antecedency and thus no preference.

It is clear that the drafters intended to cover most cases such as these under (c)(5), but there is nothing in the Code that explicitly discredits the argument that was formerly made. Indeed, the reference in 547(a)(2) to new value and the statement that new value may constitute the "release by a transfer of property previously transferred" suggests that the argument is still alive.

Assume two transfers that would not be protected by (c)(5) but might be saved by the new value rule. In the first the debtor acquires after-acquired collateral during the preference period that is neither inventory nor receivables (and so not covered by (c)(5)). A farmer trades in his old combine (equipment) that was subject to a security interest in return for

23. Assuming the payment is not saved as an ordinary course payment or under one of the other subsections of (c).

a new one to which the security interest attaches under the after-acquired property clause. If this transfer is preferential under (b), it is not saved under (c)(5) for the security is not in "inventory or a receivable or the proceeds of either." Second is the case in which (c)(5) does not save a transfer of after-acquired inventory because the unsecured gap is closed (position improved) by the acquisition of additional inventory in the ninety-day period.

Are either or both of these saved by the creditor's argument that new value was given in the form of the release of the old collateral? The creditor will argue specifically that there was no preference under (b)(2) because the transfer was not on account of an antecedent debt, but rather on account of current value, namely the release of the existing collateral. Or the creditor might claim that the transfer is saved by (c)(1) because the transfer was substantially contemporaneous and for new value.

The creditor's argument in the combine case seems completely consistent with law and policy. If the debtor chooses to give up an old combine and get a new one, none of his other creditors is hurt by the fact that the security interest that formerly attached to the old combine attaches to the new.²⁴

The second case is not as easy. The build-up of inventory case is exactly the case made a preference by the new 547(b) and one intentionally *not* saved by (c)(5). One way to protect the transfer of the combine, but not the building up of inventory is to require equivalence between new value (inventory sold or released) and new collateral (new inventory acquired). Thus, one might say that new value was given for the new combine only to the extent of the value of the old. If a \$25,000 combine was traded for a \$50,000 combine, only \$25,000 of new value is given. Yet under (b)(2) we seldom look behind the bargain to determine whether one party appeared to give 100 for another's 90. In those cases typically we assume that the value traded was equal and the antecedency exists or it does not, but that it does not come in degrees.

Take the following example as illustrative: The debtor owes the secured party \$2,000,000 under a preexisting loan secured by debtor's present and after-acquired "inventory and receivables." Under the security agreement, the debtor must get authorization from the creditor to release the collateral and obtain new collateral. Ninety days before bankruptcy the secured party has a perfected security interest in debtor's \$1,600,000 inventory. Thirty days before bankruptcy the debtor finds another merchant willing to "swap" his inventory of swim caps and goggles, for the debtor's swimsuits. The debtor and the merchant agree the inventory is of "approximately the same value." Twenty-days before bankruptcy the debtor acquires permission from the creditor to turn over the inven-

24. We are assuming here the debtor does not sweeten the security interest in the new combine by increasing his equity with some additional cash paid to the seller of the combine.

tory in exchange for the inventory of swimcaps and goggles. The creditor is unaware of the exact value of the new inventory. On the date of the petition the debt is \$2,000,000 secured by debtor's inventory of caps and goggles with a value of \$2,000,000.

When the trustee attacks this preference, the creditor could use 547(c)(5). Under a "net improvement" test, the creditor could save only \$1,600,000, the other \$400,000 would be preferential.²⁵ Measuring the collateral and the debt ninety days before bankruptcy the gap was \$400,000 (\$2,000,000 debt-\$1,600,000 collateral). On the date of the petition the gap has been reduced to \$0 (\$2,000,000 debt-\$2,000,000 collateral). This reduction of \$400,000 was caused by the "transfer" of a security interest to the creditor.

The creditor can argue that (b)(2) has not been met, or that (c)(1) applies and the entire \$2,000,000 may be saved. If value need not be precisely equivalent, it does not matter that the \$1,600,000 of inventory was traded for \$2,000,000 of inventory. Because creditor gave new value (releasing its lien on the old inventory) the creditor did not receive a transfer for antecedent debt, and the entire transaction should be saved by (b)(2).

In the alternative, the creditor might point to 547(c)(1). Inasmuch as (c)(1) protects a transfer "to the extent" that the transfer satisfies the requirements of the section, comparison of value may be invited by (c)(1).²⁶ This reading of (c)(1) would save only \$1,600,000 of the transfer and leave \$400,000 as preferential. Despite the language of (c)(1) a preference of \$400,000 in this situation does not necessarily serve the purpose of (c)(1). A primary justification for 547(c)(1) is that a transaction fitting the exception does not truly diminish the debtor's estate. If the debtor's estate is diminished, then other creditors are hurt and the transaction should be preferential. In our example, the debtor's estate has not been diminished and no other creditors have been hurt. The secured creditor would have received the collateral upon liquidation under the security agreement and the increase in value of the collateral was merely fortuitous. The debtor was able to find a merchant to swap inventory of a higher value for inventory of a lesser value. This situation is analogous to the creditor who benefits from a natural market increase in his collateral prior to bankruptcy. Such a creditor is not penalized because of a fortuitous rise in the value of its collateral in the market place.

We are not certain about the correct answers here. Surely the drafters

25. We assume that the \$400,000 portion of the value would be "to the prejudice of other creditors" under (c)(5).

26. The Tenth Circuit in *In re Rodman*, 792 F.2d 125 (10th Cir. 1986), concluded that (c)(1) is met if the debtor gets any value for the exchange when the exchange takes place. One may disagree with the court's reasoning in this case. The literal language of the definition of "new value" does not necessarily include every release of an unavoidable transfer. One may argue that the definition is limited to "moneys worth" and this definition implies valuation.

intended some restriction on the exchange of collateral notion or they would not have included (c)(5) in the Code, but it seems equally clear that some remnants of the pre-Code arguments survive.

III. DATE OF LIQUIDATION CONUNDRUM

Although Section 547(b) instructs one to compare what a particular creditor received as a result of a transfer, with what that creditor would have received on liquidation without that transfer, the statute does not tell when this hypothetical liquidation should occur. In some cases it will be important to know whether the hypothetical liquidation is deemed to have occurred at the time of the alleged transfer, at the time the petition was filed, or at some later time. There is some law on this question, but it is not completely satisfactory.

Assume that fifty days before bankruptcy debtor pays off its \$2,000,000 secured debt. The debt was secured by General Motors stock which is then worth \$2,000,000. If the General Motors stock is worth only \$1,000,000 at bankruptcy, can the trustee successfully challenge the payment to the secured creditor?

The payment to the secured creditor meets the requirements of 547(b)(1) through (4). Whether the trustee can meet (b)(5) turns on the timing of the "hypothetical liquidation." If one concludes that the liquidation occurs at the time of the payment, there is no preference because (b)(5) is not met (a \$2,000,000 payment on a debt secured by \$2,000,000 in collateral does not enable the creditor to do better than at liquidation, if liquidation occurred at day fifty). If liquidation is deemed to have occurred at the date of the petition, the trustee meets (b)(5).

*Palmer Clay Products Co. v. Brown*²⁷ is often cited for the proposition that liquidation is deemed to have occurred at the date of filing the petition. In *Palmer Clay Products Co.*, the debtor, Metropolitan Builder's Supply Company, made a partial payment of a creditor's claim during the preference period. The creditor argued that the date of "hypothetical liquidation" should be the date on which payment was made, and the payment should not be considered preferential "provided the debtor's assets at the time of the payment would, if then liquidated and distributed, be sufficient to pay all the creditors of the same class an equal proportion [i.e., as much as Metropolitan Builder Supply received] of their claims."²⁸ Justice Brandeis rejected this argument:

Whether a creditor has received a preference is to be determined, not by what the situation would have been if the debtor's assets had been liquidated and distributed among his creditors at the time the alleged preferential payment was made, but by the actual effect of the payment as determined when bankruptcy results. The payment on account of say ten percent

27. 297 U.S. 227, 228 (1936).

28. *Id.* at 228.

within the four months [four months was the preference period under Section 60] will necessarily result in such creditor receiving a greater percentage than other creditors, if the distribution is less than 100 percent.²⁹

The Court was clearly right in rejecting the creditor's claim, but we would state the rule differently than Justice Brandeis did. By hypothesis any unsecured creditor who receives a partial payment within the preference period and does not simultaneously waive the remainder of its claim will receive more than other similarly situated creditors who receive a distribution only at bankruptcy. That would be true whether liquidation were to occur the date the payment was made or at some later date. To see why, consider the following example that illustrates the rationale of the decision in *Palmer*. Suppose a debtor with assets of \$1,000,000 has ten unsecured creditors each owed \$1,000,000 ninety days before bankruptcy (a total of \$1,000,000 in assets and \$10,000,000 in debt). Forty-five days before bankruptcy the debtor pays one creditor \$100,000. On the date of bankruptcy \$900,000 remains in the pool of assets to be distributed to the creditors. Under the creditor's argument in *Palmer*, because there are ten creditors, each is going to receive a ten percent dividend from the pool of assets at bankruptcy. Each would receive 1,000,000 or \$100,000. Therefore, when Creditor 1 was paid \$100,000, the other nine creditors could have received \$100,000 each on liquidation.

To see the flaw in this reasoning, follow this creditor's argument to its conclusion. By receiving \$100,000 before bankruptcy, the creditor receives a 10 percent dividend but retains an unpaid claim of \$900,000. On bankruptcy there will be \$900,000 in the estate, the other nine unsecured creditors will each assert claims of \$1 million, and Creditor 1, who received the \$100,000 payment, will assert a claim of \$900,000. In the bankruptcy liquidation therefore, Creditor 1 would receive an additional \$81,818 for a total of \$181,818. The other nine creditors by comparison would receive only \$90,909. Clearly it is no answer to a preference claim that the amount of one's payment was less than the amount one would have received if there were liquidation on the date he received the payment. That is because he will take that payment and yet another one on bankruptcy and so will be preferred over the other parties.

The creditor in *Palmer Clay Products Co.* did not give up its claim. What if the creditor had forsaken all future claims against the debtor in return for the payment? Would the Supreme Court have still found that payment to be a preference to Creditor 1? If Creditor 1 had made this promise to forsake all future claims then the remaining creditors would have received \$100,000 on the date of bankruptcy (1/9th of \$900,000), the same amount they would have received had the payment not been made to Creditor 1 (1/10th of \$1,000,000). In that case a court could find that the date of "hypothetical distribution" should be the date at

29. *Id.* at 229.

which the payment is made. When one considers a secured creditor who is paid, as in our example, the timing becomes critical.

*In re Tenna Corp.*³⁰ also bears on this question. Tenna Corporation had made a \$527,264.37 payment to the IRS for back taxes; the trustee claimed that the payment was preferential. After Tenna had filed in Chapter 11 it borrowed substantial funds to continue its operation and granted the lenders superpriority liens on all of its property.³¹ The effect of these liens was to reduce the dividend that could ultimately be paid to unsecured creditors from the amount that would have been paid if liquidation had occurred on the date of the petition. Several months after the postpetition loans had been made, Tenna's trustee attacked the IRS payment as preferential. The trustee argued: "the date of the hearing on the adversary proceeding is the appropriate testing date because 547(b) requires that the actual anticipated distribution to all creditors owed by the debtor be included in the determination."³² The IRS claimed that "a hypothetical Chapter 7 liquidation can be constructed as of the date the petition in bankruptcy was filed."³³ The district court determined that the appropriate date should be the date of the adversary proceeding and found the payment a preference.³⁴ The superpriority liens were superior to the IRS liens, and because these liens had a value greater than that of the estate at the date of the adversary proceeding, payments to the IRS were preferential as they were made within the preference period and were to the benefit of the IRS. The Court of Appeals reversed and stated that using the date of the adversary proceeding would be "inconceivable and illogical," for it would allow the trustee to manipulate the time of the proceedings so as to ensure that the transfer was a preference.³⁵ Therefore, the court found that the date of the petition in bankruptcy should be the testing date for the "hypothetical distribution."

Because we assert that the date of the hypothetical liquidation should be *before* the date of the petition, *Tenna* does not speak directly to or conflict with our case. But what about *Palmer Clay Products Co.*? It is similar to the illustration we have put forth, and it points to the date of the petition in bankruptcy, not to the date of the payment.

In our illustration (\$2,000,000 payment on a loan secured by \$2,000,000 in stock), the trustee might argue that the secured creditor has received a \$1,000,000 preference. The creditor was paid \$2,000,000 fifty days prior to bankruptcy, yet it would have received only \$1,000,000 (the value of the collateral on the date the petition was filed) together with a distribution to unsecured creditors if liquidation took place on the date the bankruptcy petition was filed. However, as Justice Brandeis stated in *Palmer Clay Products Co.*, the "hypothetical liquida-

30. 801 F.2d 819 (6th Cir. 1986).

31. *Id.* at 820.

32. *Id.*

33. *Id.* at 821.

34. *In re Tenna Corp.*, 53 B.R. 493 (D.C. Ohio 1984).

35. *In re Tenna Corp.*, 801 F.2d 819, 823 (6th Cir. 1986).

tion" is not measured at the time of the actual payment, but by "the actual effect of the payment when bankruptcy results. . . . A payment which enables the creditor to obtain a greater percentage of his debt than any other of such creditors . . . is a preference."³⁶

Must the payment *cause* the creditor to receive a greater share? In our illustration the combination of the payment and the decline in value of the collateral *causes* the secured creditor to receive a greater portion of its debt at the time of payment than it would have received if it had waited. In our illustration the creditor was fully secured. Had there been no payment but the collateral had still been worth \$2,000,000 at the date of bankruptcy, the creditor would have received \$2,000,000. Only because the collateral declined in value by the date of the petition did the creditor receive a greater amount than it would have received on liquidation at the date of the bankruptcy petition. In our example, the secured creditor who has been paid will not have any future claims. It will make no claim to the "pool" of assets at the date of the petition in bankruptcy as would the creditor in *Palmer Clay Products Co.*

What arguments support the date of transfer as the date of the potential liquidation? One way to approach the question is to ask who bears the risk of depreciation. In our illustration, the secured creditor has accepted full satisfaction of its debt (\$2,000,000) and relinquished its right to any future claims against the debtor. When the collateral declines in value (\$1,000,000 at the date of bankruptcy) the unsecured creditors suffer the loss by receiving a smaller payout from the trustee. Where there are secured and unsecured creditors, is it not appropriate that the unsecured creditors bear the risk of the decline in value of the collateral after the secured creditor has been paid? The unsecured creditors also reap the gain from appreciation. If, in our illustration, the collateral were worth \$4,000,000 at the date of bankruptcy instead of \$1,000,000, each of the unsecured creditors would gain from the increase in the value of the collateral at the date of bankruptcy, while the secured creditor would have no claim to the excess.

A second way to approach the policy question is to treat the secured creditor as the owner of an interest in the collateral. When the creditor took an original security interest in the collateral and loaned debtor \$2,000,000, there was a conveyance to the creditor.³⁷ Arguably, the debtor's payment causes a reconveyance of the collateral from the creditor to the debtor, thus making the reconveyance end the transaction and no later events should change it.

To show that we are not merely apologists for secured creditors, consider a second case. Assume there is \$2,000,000 of debt fifty days before bankruptcy, but the General Motors stock is worth only \$1,000,000. On that day debtor pays creditor \$2,000,000. Between the fiftieth day and

36. *Palmer Clay Products Co. v. Brown*, 297 U.S. 227, 229 (1936).

37. U.C.C. §9-203. Under 9-203 the debtor has made a conveyance by granting a security interest to the creditor.

the date of bankruptcy, the General Motors stock appreciates to \$2,000,000. What result now? To be consistent we must say that the liquidation should be deemed to have occurred on the date the payment was made fifty days prior to bankruptcy. The creditor has received a \$1,000,000 preference. In the hypothetical given, all of the appreciation between the fiftieth day and the date of bankruptcy should go to the unsecured creditors, not so?

A final reason for treating the date of the payment as the date when the hypothetical liquidation is the anomalous result that would otherwise occur if the creditor takes collateral in full satisfaction instead of taking payment of the debt. Assume in our original example the creditor agreed to discharge the liability in return for a quitclaim to the collateral. Presumably that would not be a preference, since the asset would no longer belong to the estate, and there would be no question of liquidation on the date the petition was filed. If the secured creditor, having taken the collateral in full satisfaction, sold it the next day, it would be fully satisfied. If it held the stock until it declined, that would be the creditor's loss. None of these things would be of any concern to the debtor or the unsecured creditors.

If we do not choose the date of the transfer as the date of the hypothetical liquidation, one gets indefensible differences between the creditor who takes the collateral in full satisfaction and the creditor who takes the payment instead. Neither of the creditors has hurt the estate because neither will be making any future claims on the estate.

IV. INDIRECT BENEFIT CONUNDRUM

The possibility that a payment to one creditor can be a preference to another and so recoverable from either poses delightful problems. Some of these are examined in the notorious *Deprizio* case.³⁸ We carry on from that case. Assume the following: Ninety days before bankruptcy, Creditor 1, a senior creditor, has a \$600,000 loan secured by the debtor's inventory worth \$600,000. Creditor 2, a junior secured creditor, is owed \$200,000 and has a security interest in the same inventory. Seventy days before bankruptcy, the debtor pays Creditor 1 in full, and Creditor 1 releases his security interest in the collateral. Since the debt was fully secured (\$600,000-\$600,000 value of collateral) the trustee cannot attack the payment directly because of 547(b)(5).

But Section 547(b)(1) states that a transfer is avoidable "if it is to or for the benefit of a creditor." This section does not limit "creditor" to Creditor 1 who received the payment. The "benefit" can be to any creditor of the debtor. If the trustee can show that Creditor 2 was benefited by the payment to Creditor 1, the trustee can avoid the payment as preferential. Worse, if the payment is preferential, Section 550 allows the trustee to recover it from either the initial transferee (Creditor 1) or the

38. *Levit v. Ingersoll Rand Financial Corp.*, 874 F.2d 1186 (7th Cir. 1989).

"entity for whose benefit such transfer was made" (Creditor 2).³⁹ This would allow the trustee to force either Creditor 1 or Creditor 2 to make the payment in the amount of the preference to the trustee's pool of assets to be distributed at bankruptcy.⁴⁰

Following the approach in *Deprizio*, the trustee in our hypothetical will attack the payment in full to Creditor 1 as preferential to Creditor 2 because the payment transformed Creditor 2 from an unsecured creditor to a fully secured creditor. This would create a preference under Section 547. Turning to Section 550 the trustee will argue that it can recover from either the initial transferee (Creditor 1) or the beneficiary of the transfer (Creditor 2). This case poses several problems. First, should the payment to the senior creditor be a preference to the junior creditor? Second, when should the recipient of the transfer (Creditor 1) have to repay the money to the trustee under Section 550? Third, when there are two creditors and payment to one benefits another, how does one apply

39. §550 states: . . . (a) Except as otherwise provided in this section, to the extent that a transfer is avoided under section . . . 547 . . . the trustee may recover, for the benefit of the estate, the property transferred, or, if the court so offers, the value of such property, from—

(1) the initial transferee of such transfer or the entity for whose benefit such transfer was made; or . . .

11 U.S.C. § 550 (Supp. IV (1980)).

40. In *Levit v. Ingersoll Rand* ("Deprizio"), 874 F.2d 1186 F.2d (7th Cir. 1989) the debtor company, Deprizio Construction, went bankrupt. Deprizio had obtained many of its loans from creditors by having Richard Deprizio, the President of the company, guarantee the loans. Between ninety days and one year before the date of bankruptcy, Deprizio Construction had made payments on three types of obligations: (1) obligations guaranteed by Richard Deprizio; (2) tax obligations; and (3) pension fund obligations. The trustee argued that these transfers were preferential as they had been made to the benefit of an inside creditor, Richard Deprizio, and made within one year of bankruptcy (the preference period for insiders). The trustee stated that a guarantor is a creditor under the Code because a creditor is anyone holding a claim against the debtor. The guarantor holds a "contingent claim" against the debtor that becomes fixed when the guarantor pays the creditor whose claim was guaranteed. By the debtor's paying off loans subject to the guarantee, the guarantor had benefitted because the payment reduced the exposure of the guarantor. Consequently, all payments made by the debtor directly to oblige a guaranteed obligation are avoidable as transfers not only "to" the creditor, but "for the benefit of" the creditor guarantor. The trustee argued that despite the fact that the payment was to an outside creditor and before the ninety day preference period, the payment was still preferential because the effect was to benefit an insider, whose preference period is one year.

In the major portion of the court's opinion, Judge Easterbrook agreed with the trustee, holding that transfers preferentially benefitting insider guarantors are voidable when such transfers take place more than ninety days before filing a petition, but within one year of bankruptcy. Any such guarantor has an incentive to favor (pay off) guaranteed loans as compared with other loans.

The creditors of the guaranteed loans argued that each payment was two "transfers"—one to the creditor and another to the guarantor, and that the only transfer avoidable under § 547 is the one to the guarantor. Judge Easterbrook disposed of this argument stating that there was no legislative history to support this argument. He found a single payment to be one transfer, "no matter how many people gain thereby."

Section 547(c)?

SHOULD THE PAYMENT TO CREDITOR 1 BE A PREFERENCE TO CREDITOR 2?

Suppose that the debtor pays off Creditor 1, takes possession of and dissipates the collateral between the date of payment to the fully secured creditor (Creditor 1) and the date of bankruptcy. The trustee will claim that the junior creditor has “benefited” from the payment to Creditor 1 because the junior creditor’s status has been improved to that of a senior creditor with respect to the collateral. However, Creditor 2 may respond that although its status was theoretically improved, it has not actually benefited because the collateral has been dissipated.

This case is slightly different than *Deprizio*, where the guarantor almost certainly received an actual benefit. If, at the date of bankruptcy, there were enough assets to pay off all creditors who had loans guaranteed by Mr. Deprizio, then he has not received an actual benefit by causing payment of a guaranteed loan. However, if the assets are not enough to pay off these creditors, then any payments to creditors whose debts he guaranteed would result in an “actual benefit” to Mr. Deprizio.

How should courts define “benefit” under 547(b)(1)? Will benefit be anything that potentially benefits the creditor, or only those things that actually benefit the creditor? In our example, it is plausible to say that because there was no actual benefit to Creditor 2, the transfer was not a preference. If one is to adopt the approach that the definition of benefit means only actual benefit, the courts will then have to decide if all actual benefits will constitute a preferential transfer. In *Deprizio*, Judge Easterbrook provided this example:⁴¹ Lender 1 extends credit for security; Lender 2 has a junior security interest. Lender 2 is backed by a guarantee. Each payment to Lender 1 increases the security available to Lender 2, which in turn produces a benefit to the guarantor by reducing its exposure. Without directly answering the question, Judge Easterbrook implied that the trustee would have an uphill battle in finding a preference. He states: “The benefit in such a case is negligible at best, so the case for recapture is weak.”⁴² This analysis implies that the courts should somehow measure the probable benefit to decide whether a preference has occurred. We endorse such an inquiry and believe wholesale avoidance would be law gone mad.

SHOULD CREDITOR 1 HAVE TO REPAY THE AMOUNT OF THE TRANSFER TO THE TRUSTEE UNDER SECTION 550?

If one concludes that there is a preferential transfer under Section

41. *Id.* at 1200.

42. *Id.*

547, Section 550 allows recovery of the transfer from either Creditor 1 or Creditor 2. Both Creditor 1 and Creditor 2 have good reasons to balk at having to repay any amount of money to the trustee. Creditor 1 will argue that it is a victim of an unforeseen circumstance. Creditor 1 was fully secured; had there been no junior creditor, the payment it received would not have been preferential under Section 547(b)(5).⁴³ Note that the creditors in *Deprizio* were not merely victims of circumstance; it is likely that they never would have received payment but for the guarantee that stimulated the corporate officers to pay some and omit others. The guarantor presumably manipulated the debtor's payments to satisfy guaranteed obligations first. Simply because a junior creditor exists, the effect of a payment to a fully secured senior creditor should not change. Why should the trustee benefit from the fortuitous event of having a junior creditor? Creditor 2 may argue that it had no way of knowing that Creditor 1 had been paid in full and surely had no control over that payment. An amendment to Section 550 contained in a bill that passed the Senate in June of 1992, but has not yet passed the House, would protect the first creditor by requiring trustee to show that all of the elements of Section 547(b) are satisfied as to the first transferee.⁴⁴

We are doubtful of the case against Creditor 2. We are certain that no recovery should be permitted from Creditor 1.

APPLYING THE 547(c) EXCEPTIONS IN TWO CREDITOR CASES

Assume that the payments by the debtor to Creditor 1 were "ordinary course" payments under Section 547(c)(2), and so not preferential.⁴⁵ If the payment to Creditor 1 was no longer preferential, does this mean the

43. Section 547(b)(5) states that in order for a transfer to be a preference the transfer must

- (5) enable such creditor to receive more than such creditor would receive if —
 - (a) the case were a case under chapter 7 of this title.

44. Section 550 of title 11 U.S.C. Sec. 204. Preferences. S.1985. Cong.Rec., June 17, 1992 S: 8359.

Section 550 of title 11, United States Code, is amended—

- (1) by redesignating subsections (b), (c), (d), and (e) as subsections (c), (d), (e) and (f), respectively; and

- (2) by inserting after subsection (a) the following new subsection:

"(b) The trustee may recover under subsection (a) a transfer avoided under section 547(b) from a first transferee or an immediate or mediate transferee on a first transferee only to the extent that—

- "(1) all the elements of section 547(b) are satisfied as to the first transferee; and

"(2) the exceptions in section 547(c) do not protect the first transferee."

45. Section 547(c) The trustee may not avoid under this section a transfer . . .

- (2) to the extent that such transfer was—

(A) in payment of a debt incurred in the ordinary course of business or financial affairs of the debtor and the transferee; . . .

transfer is no longer preferential to Creditor 2? *In re H & S Transp. Co., Inc.*⁴⁶ suggests so. Debtor, H & S, operated tug boats leased from United Liberty Life Insurance and Brent Towing Company. H & S filed for bankruptcy on September 4, 1981. Within ninety days of bankruptcy, H & S had paid various fuel suppliers for fuel purchased on credit. Maritime law gave these fuel suppliers a maritime lien that had preference over interests of the lessors, United and Brent. In effect these rules made the fuel suppliers our "Creditor 1" and the lessors our "Creditor 2" from the previous example.

The trustee claimed that the payments by H & S to the fuel suppliers released these maritime liens, and were an indirect preference to the subordinate claimants, United and Brent. The court held that payments made by H & S to the fuel suppliers during the ninety day preference period could not be recovered from those suppliers because "sufficient amounts of new value were extended [to H & S] subsequent to the preferential transfers to offset the transfers."⁴⁷ United and Brent argued that the trustee was also precluded from recovering the transfer from them. The bankruptcy court disagreed, stating that two preferential transfers may result from one transaction. The United States District Court overruled; it rejected the "two transfer" theory. Stating that the courts have found that a single payment is one transfer no matter how many people benefit, the court allowed Brent and United to use the suppliers' "new value" defense. "To allow recovery also from United and Brent would amount to two satisfactions of a single transfer."⁴⁸

The *H & S* case relies in part on Judge Easterbrook's holding and dictum in *Levit v. Ingersoll Rand Financial Corp.*⁴⁹ In a long dictum Judge Easterbrook endorses the proposition that the second or "benefitted" creditor is protected by the full security of the original creditor or by any of the exceptions that the original creditor (Creditor 1) can assert under 547(c). Thus, if the payments are ordinary course payments protected *vis à vis* Creditor 1 under 547(c)(2), they are not preferential under Creditor 2 either.

The difficulty with carrying Judge Easterbrook's dictum to the case of *H & S* and to our hypothetical is that he was contemplating the position of the guarantor of the debt, not the position of a subordinate secured creditor. When the payment to a creditor releases a guarantee against that debt, but is not preferential (because, for example, the creditor is secured), no other creditor can be injured by this transaction and the guarantor should clearly be protected from any preference claim. The

11 U.S.C. 547(c)(2)(Supp. IV 1980).

46. 110 B.R. 827 (M.D. Tenn. 1990). See also, *In re H & S Transp. Co., Inc.*, 80 B.R. 441 (Bankr. M.D. Tenn. 1987), *reversed and vacated*, *In re H & S Transp. Co., Inc.*, 90 B.R. 309 (M.D. Tenn. 1988); *reversed by In re H & S Transp. Co., Inc.*, 878 F.2d 381 (6th Cir. 1989), *on remand*, *In re H & S Transp. Co., Inc.* 110 B.R. 827 (M.D. Tenn. 1990).

47. *Id.* at 830.

48. *Id.* at 832.

49. 874 F.2d 1186, 1199-1200 (7th Cir. 1989).

same is not true when the party benefited by the payment is a subordinate secured creditor with a different claim. In the first case the payment releases the collateral to the general creditors. In the second case (that involving a subordinate secured creditor) the asset is not released to the general creditors, but instead goes to the subordinate secured creditor who was formerly unsecured and who by the transfer becomes partly or wholly secured. Thus, the cases are distinguishable and the latter cases are not as easy as the former.

One might argue that even though there is only one transfer and even though the transfer is not preferential as to the first claimant because of 547(b)(5) (or because of one of the exceptions in (c)), it could nevertheless be preferential as to the second party (the benefited creditor) and that person would have to demonstrate its own defense. While we are sympathetic to the outcome in *H & S* and are generally doubtful that indirect preferences of the kind that might result when there is payment of the first secured creditor to the second should be recognized, we do not believe that Judge Easterbrook's reasoning can be carried through wholesale. The proposed amendment to Section 550 discussed above in footnote 44 would also protect the initial transferee if that transferee fit under any of the exceptions to 547(c). It would not, however, protect our second subordinate secured creditor who is indirectly benefited.

V. CONCLUSION

Labeling these questions conundrums signals our uncertainty about the proper outcomes. While we are certain about what the law ought to be, we are less certain about what it is. We will have fulfilled our job if we have demonstrated the silliness of the outcomes that might occur if Sections 547 and 550 are driven to their extreme.