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UNDERSTANDING PREFERENTIAL TRANSFERS

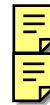
WILLIAM H. WIDEN*

USING THIS OUTLINE

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The outline has been locked to inhibit printing. You must use the outline on a computer to take advantage of all its features in any event, so do not complain. Various sections of the **Uniform Commercial Code** (“UCC”) and the **United States Bankruptcy Code** (“Code”) have been highlighted by color, shading and underlining to illustrate various features of the relevant statutes. Further, you may click on various colored icons for additional commentary on selected UCC and Code sections that appear below.

Note that "Code" is reserved for the Bankruptcy Code and that "UCC" is reserved for the Uniform Commercial Code.



References to **TEXT** are to **JORDAN, WARREN & WALT, COMMERCIAL LAW**, Fifth Edition (Foundation Press 2000).

This text is not as bad as you all think.

WHAT IS A PREFERENTIAL TRANSFER?

The Code does not define the terms “preference” or “preferential transfer.” Instead, in Section 547(b) of the Code, we find a description of a type of transaction that the bankruptcy trustee for a debtor may undo. The general idea is to allow the trustee to undo or “avoid” certain **transfers** of property or interests in property made by a debtor shortly before the debtor files for bankruptcy. To be avoidable, the transfer must have enabled the creditor to receive a larger percentage payout on its **claim** than it would have received if the creditor had not received the transfer and instead had received a distribution on its claim in a hypothetical liquidation of the debtor under Chapter 7 of the Code. The rationale for the rule is that these types of pre-bankruptcy transfers of property are unfair to existing unsecured creditors who do not receive a “preferred” early pre-bankruptcy payment or other transfer. Further, if a creditor must return such payments or lose the benefit of another form of transfer such as the creation of a security interest, the incentive for a creditor to hound a debtor for early repayment or additional collateral before an expected bankruptcy is reduced.



*Associate Professor, University of Miami School of Law; 1311 Miller Drive, Coral Gables, Florida 33146; wwiden@law.miami.edu. Professor Widen’s course website appears at <http://ucstuff.com>.

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This discourages the race to dismember a debtor prior to filing and may result in fewer bankruptcies. Should bankruptcy come anyway, elimination of efforts to dismember the debtor prior to filing may lead to more successful reorganization of debtors who do file for bankruptcy protection.

For our purposes, there are **two** classic preferential transfer **paradigms**: the **repayment of a debt** and the **creation of a security interest**.

Repayment of Debt as a Preference

In the case of repayment of a debt, the scenario is simple. Debtor (“**D**”) borrows money, say \$100, from Creditor (“**C**”) at time T1 on an **unsecured** basis. Time passes and, at time T2 (say two years later), D repays the \$100 loan to C. Shortly thereafter, at **T2 plus 75 days**, D files for bankruptcy.

Now, C is quite pleased that it received repayment of its loan shortly before bankruptcy. In D’s bankruptcy, the remaining unsecured creditors will each receive repayment of only a fraction of their claims. Imagine that D has \$300 in assets and the remaining unsecured creditors are owed \$900. While these remaining creditors will receive only one third of the amount that they are owed, C was repaid in full. If C had not been repaid shortly before D’s bankruptcy, D would have \$400 in assets (*i.e.* the \$300 in assets plus the \$100 not paid to C) and unsecured creditors holding \$1,000 in claims (*i.e.* the \$900 in remaining unsecured creditor claims plus the \$100 owed to C). In such a case, C and the other unsecured creditors would receive 40% of the face amount of their claims. It is easy to see that C benefitted from the early repayment because it received more than it would have received in a liquidation of D’s assets if the early repayment had not taken place (*i.e.* a 100% repayment versus a 40% repayment).

Also, it is easy to see why the bankruptcy trustee for D is motivated to avoid the early repayment made to C. By avoiding the transfer to C and recovering the \$100 payment, the total assets available for distribution to unsecured creditors is increased to \$400, with the result that unsecured creditors receive a payment of 40% on their claims rather than 33%.

Note that this repayment constituting a preference is a repayment of an **unsecured** loan. If the \$100 loan from C had been fully secured by a security interest in all of D’s assets, there would not have been an avoidable transfer because C would not have received more than it would have received in a Chapter 7 liquidation of D. The repayment of a secured loan only creates a potential preference if the security interest is **unperfected**² or

² Remember that a secured creditor may also hold an unsecured claim if the collateral is worth less than the total amount of the claim. Repayment of an undersecured creditor may result in an avoidable preferential transfer to the extent that the unsecured deficiency claim was paid.



the security interest was deemed to be created after the debt was incurred, in each case as more fully described below.

Creation of Security Interest as a Preference

In the case of creation of a security interest, also the scenario is simple. Debtor (“D”) borrows money, say \$100, from Creditor (“C”) at time T1 on an **unsecured** basis. Time passes and, at time T2 (say two years later), C demands that D create a security interest in all of its assets to secure repayment of the \$100 loan to C.³ Shortly thereafter, at **T2 plus 75 days**, D files for bankruptcy.



Now, C is quite pleased that it received the grant of a security interest to secure its loan shortly before bankruptcy. In D’s bankruptcy, the remaining unsecured creditors will each receive repayment of only a fraction of their claims. Imagine that D has \$400 in assets and the remaining unsecured creditors are owed \$900. C will receive repayment of its \$100 loan out of the \$400 in assets in which it holds a security interest. After this \$100 payment, \$300 in assets remain for distribution to the unsecured creditors. While these remaining unsecured creditors will receive only one third of the amount that they are owed, C was repaid in full. If C had not been granted a security interest shortly before D filed for bankruptcy, D would have \$400 in unencumbered assets and unsecured creditors holding \$1,000 in claims (i.e. the \$900 in remaining unsecured creditor claims plus the \$100 owed to C that we hypothesize to be unsecured because we assume the transfer of the security interest did not take place). In such a case, C and the other unsecured creditors would receive 40% of the face amount of their claims. It is easy to see that C benefitted from the creation of the security interest because it received more than it would have received in a liquidation of D’s assets if the creation of the security interest had not taken place (i.e. a 100% repayment out of the collateral versus a 40% repayment *pro rata* with the other unsecured creditors).


Also, it is easy to see why the bankruptcy trustee for D is motivated to avoid the security interest granted to C. By avoiding the transfer of collateral to C and preserving the security interest for the general benefit of D’s bankruptcy estate, the total assets available for distribution to unsecured creditors is increased to \$400, with the result that unsecured creditors receive a payment of 40% on their claims rather than payment of 33%.




³ Take a look at UCC Section 1-208 for an example of a provision that might entitle a creditor to demand collateral after the initial extension of credit is made. Some creditors negotiate to receive a so-called “springing lien.” The lien springs into existence at the request of the creditor, either at will or if the creditor deems itself to be insecure. The UCC modifies such clauses so that the creditor can only make the demand if, in good faith, the creditor believes that the prospect of payment or performance is impaired.

It is a good idea to learn the terms used to describe various types of clauses and covenants. You should know: granting clause, future advance clause, after acquired property clause, springing lien, negative pledge and equal and ratable clause.

Warning About Antecedent Debt



In the case of the creation of the security interest that constituted an avoidable preference, note that the creation of the security interest occurs **after** the creation of the claim secured by the security interest. The loan was made at T1 and the security interest was created two years later, at T2. The loan thus was **antecedent** (*i.e.* before) the creation of the security interest. The creation of the security interest is a **transfer** of debtor property within the meaning of the Code (albeit a transfer of a limited interest). This later-in-time transfer of a security interest to secure a pre-existing debt thus is seen to be a transfer in respect of **antecedent debt** just as the repayment of a loan is a transfer of debtor property in respect of **antecedent debt**. Contrast transfers in respect of antecedent debt with contemporaneous exchanges. The general idea of a contemporaneous exchange is that if C had loaned D \$100 at T1 and also received a security interest from D at T1, then there is no transfer of debtor property in respect of **antecedent debt**. Instead, there was a simultaneous creation of a debt (*i.e.* the \$100 loan) and transfer of an interest in debtor property (*i.e.* the grant of the security interest by D to C).



However, this simple timing picture is complicated by special rules used to determine when a transfer of a security interest takes place within the meaning of the Code. The general idea of the timing rule found in Section 547(e) is that a transfer of a security interest is not deemed to occur at the time D grants a security interest to C (*e.g.* generally, the transfer does not occur at the time of attachment under Section 9-203 of the UCC). Instead, the transfer of the security interest is deemed to occur only if the security interest is perfected. Thus, if C loans \$100 to D at T1 and, also at T1, D signs a security agreement covering all its assets to secure this \$100 loan, a transfer of a security interest has not yet occurred. Instead, the transfer of the security interest occurs, for purposes of the Code, only if C files its financing statement to perfect this security interest.

As we shall see later in this outline when we review the terms of Section 547, the Code actually uses three separate timing tests, all keyed to perfection. If C perfects its security interest shortly after attachment (within 10 days for most security interests, and perhaps, 20 days in the case of a PMSI), then, and only then, do we treat the security interest as having been a transfer at the time of attachment. If the security interest is perfected after the expiration of the applicable grace period, then the security interest is deemed to be a transfer that occurs at the time of perfection, not the time of attachment. If the security interest is never perfected, then we pretend that the security interest was perfected immediately prior to the time that D filed

for bankruptcy.⁴

This timing rule that links the time of the transfer of an interest in debtor property in the form of a security interest to the time of perfection of that security interest (rather than to the time of attachment) creates the possibility that transfers of security interests that appear, as a commercial matter, to be contemporaneous exchanges, in fact under the Code are treated as transfers in respect of antecedent debt. A similar timing trap affects after acquired property.

Warning About After Acquired Property

In the case of creation of a security interest in after acquired collateral, also the scenario is simple. Debtor (“D”) borrows money, say \$100, from Creditor (“C”) at time T1 on a fully secured basis. D signs a security agreement that covers all of its now owned and hereafter acquired equipment. C properly files a financing statement at T1. Time passes and, at time T2 (say two years later), D acquires a new machine that makes widgets. The security interest in the machine can not attach until D acquires the machine because it is not until that time that D has rights in the machine. D must have rights in the collateral before a security interest may attach under UCC Section 9-203. Shortly thereafter, at **T2 plus 75 days**, D files for bankruptcy. Under the Code, at what time did the transfer of the security interest in the new machine take place?



There are two obvious choices: the transfer of the security interest in the machine might be deemed to have occurred back at T1 when C filed its financing statement; or, the transfer of the security interest in the new machine might be deemed to have occurred when D acquired the machine at T2 and the machine first became subject to the security interest of C. Under Section 547(e)(3), the Code chooses the later time, T2, as the time of the transfer of the security interest in the new machine. There is no deemed relation back to the time of filing of the financing statement to keep the transfer of the security interest and the creation of the debt simultaneous. This means that anytime D acquires property shortly before filing for bankruptcy, if that property is subject to an after acquired property clause in a security agreement, the acquisition of that property might constitute an instance of an avoidable transfer.⁵ Though D obviously keeps its newly



⁴ Note that the trustee has the status of a hypothetical lien creditor under Code Section 544(a). Under UCC Section 9-317, a lien creditor may defeat an unperfected security interest. Thus, the unperfected security interest may lose on two counts—both as a preference and as against the lien creditor.

⁵ This causes a significant problem for security interests in inventory and receivables because they turn over with such regularity. A pool of receivables owned by D at time T1 may have a value of \$1 million. At time T2 (say, 90 days later) D also may own a pool of receivables with a value of \$1 million. However, all of the individual receivables outstanding

An example of the problem described in this footnote appears later in the text.

acquired asset (it is not the acquisition of the assets that is avoided!), D's bankruptcy trustee may avoid C's security interest in the after acquired collateral under certain circumstances.



Whether the acquisition of the new machine that becomes subject to the security interest of C based on the operation of an **after acquired property clause** constitutes an avoidable transfer of an interest in debtor property depends on whether C was over secured or under secured by existing collateral at the time D acquired the new machine. If D owned equipment worth \$60 immediately prior to T2 and D also owed C \$100 secured by equipment owned by D at that time, C is under secured by \$40. When D acquires a new machine at T2 that is worth, for example, \$50, and that machine becomes subject to C's security interest by virtue of the after acquired property clause, C has improved its position. Its unsecured deficiency of \$40 has been reduced to \$0.

The reduction of C's unsecured deficiency from \$40 to \$0 by virtue of the transfer of a security interest in the new machine enables C to receive more in D's bankruptcy than it would have received in the absence of the creation of the security interest. If the transfer of a security interest occurs shortly before bankruptcy, this reduction in the unsecured deficiency is an improvement in position resulting from the security interest in the after acquired collateral. The trustee may avoid this transfer and preserve it for the benefit of D's bankruptcy estate.

Note that the timing rule under the Code differs from the timing rules found in the UCC that relate to priority of security interests in after acquired collateral. Under the UCC, if C files its financing statement at T1, C's priority in the newly acquired machine purchased at T2 as against other secured parties (other than a PMSI with respect to the new machine) is measured from T1, the date of C's filing of its initial financing statement. **See Section 9-322.** Similarly, C's priority in the newly acquired machine as against other lien creditors will be measured from the time C files its financing statement and signs a security agreement. If both these steps are taken prior to the time a person becomes a lien creditor, C will have priority



at T1 might have been paid prior to T2 so that the entire pool of receivables owned by D at T2 consists of property newly acquired by D within the 90-day preference period prior to a bankruptcy filing by D. As these new receivables come into existence, they would become subject to a security interest created by a security agreement with an after acquired property clause. Indeed, for inventory and receivables, case law has held that an after acquired property clause may not even be needed. See *In re Filtercorp, Inc.*, 163 F. 3d 570 (9th Cir. 1998)(**TEXT 34**). In the case of inventory and receivables, a special rule, Section 547(c)(5), protects financing secured by inventory and receivables from the type of preference attack that might be raised against after acquired equipment. Only a creditor that improves its position will lose its interest in after acquired collateral. These special rules are discussed later in this outline.

over the lien creditor in the after acquired collateral. **See Section 9-317(a)(2)(B).**

Warning About “to or for the benefit of a creditor”

In the above examples, in each case D made a transfer of its property to C, either in repayment of debt or by creation of a security interest. However, a transfer might constitute a preference if the transfer is made **for the benefit of a creditor** even though the transfer is not made **to the creditor**. The paradigm case of such a benefit arises with guarantees.⁶ Suppose that C loans D \$100 at time T1. To induce C to make this loan, D arranges for its largest stockholder (“G” for “**Guarantor**”) to guarantee repayment to C of its loan. Later, at time T2, D makes repayment of its \$100 loan from C. In **scenario one**, at **T2 plus 75 days**, D files for bankruptcy. In **scenario two**, at **T2 plus 180 days**, D files for bankruptcy. Although D made a payment **to C**, this payment also was **for the benefit of G** because the payment reduced G’s contingent liability under its guarantee for repayment of the loan. As a guarantor of the loan, recognize that G was a contingent creditor of D. For, if G had made a payment on its guarantee, it would have been subrogated to the rights of C and thus had a direct claim against D for reimbursement. Thus, the payment by D to C was a payment for two creditors, both C and G.

It is crucial that G be a **creditor** of D in order to illustrate the timing complexities created by the contrast between **scenario one** (D files at T2 plus 75 days) and **scenario two** (D files at T2 plus 180 days). Assume that **C is not an insider** of D so that the timing rule for potential preferential transfers to C is simply 90 days. Assume **G is an insider** of D so that the timing rule for potential preferential transfers for the benefit of G is one year. In scenario one, D’s payment to C may be recovered from C or from G. C has no basis for complaint because it was paid in the 90 day window immediately prior to D’s bankruptcy filing. Oddly enough, at one time under the Code, under **scenario two**, D’s payment to C could be recovered from C or from G even though C received its payment outside the 90-day window prior to D’s bankruptcy filing. The reason for this anomalous result was that, even though the payment considered as a **payment to C** was not a preference because outside the 90-day window applicable to C, the payment, considered as a **payment for the benefit of G**, was a payment inside the one-year window applicable to insiders.

The problem arose because the bankruptcy trustee was not limited to seeking a recovery from G under **scenario two**. The trustee may recover a

⁶ See *Levit v. Ingersoll Rand Financial Corp.*, 874 F. 2d 1186 (7th Cir. 1989)(also known as the “Deprizio” case)(discussed at **TEXT 588**).

Now we use an example that illustrates the difference between the 90 day preference period for everyone and the extended one year period that applies to insiders.

Note how the same payment is capable of being described in two different ways. Under one description, the payment is not a preference. Under the other description, the payment is a preference. Guess which description the trustee will choose!

When reading a statute, you must be sensitive to slight changes in words. “To” has a different meaning than “for the benefit of.” It is not simply verbosity on the part of the drafters!

preferential transfer from any initial transferee or from the entity for whose benefit such a transfer was made. **See Section 550(a)**. The Code was amended to try to fix this problem by the addition of Section 550(c). It is debatable whether the technical fix was properly implemented. Nevertheless, the idea is to prevent a recovery from C where C is an outsider who receives a transfer of debtor property before the 90-day danger window applicable to unaffiliated creditors commences but nevertheless receives payment within the one-year window applicable to insiders.

The Doctrine of Earmarking as an Exception to Preferential Transfers

Before considering specific statutory defenses to a preference attack by a bankruptcy trustee for D found in Section 547(c), consider the following judge made exception to a preference attack known as “**earmarking**.”

Recall our first case of debt repayment as a preference. Debtor (“**D**”) borrows money, say \$100, from Creditor (“**C**”) at time T1 on an unsecured basis. Time passes and, at time T2 (say two years later), D repays the \$100 loan to C. Shortly thereafter, at T2 plus 75 days, D files for bankruptcy. It appears that we have a garden variety preference and, thus, C must establish a Section 547(c) defense or return its payment to D’s bankruptcy estate. Add the following twist: D obtained the \$100 to repay C from a new creditor (“**NC**”) who loaned D \$100 on an unsecured basis for the purpose of repaying C. As a matter of economic substance, NC simply has replaced C and no other unsecured creditor is worse off.

In cases such as these, courts find that the funds obtained by D from NC were somehow “earmarked” for payment to C and, thus, never really became property of D. Thus, the payment of C did not constitute a transfer of debtor property because C received “earmarked” funds. There is an argument that the doctrine of earmarking can be brought under the rubric of a Section 547(c) defense but the current state of the law treats earmarking as a separate doctrine.⁷

DEFENSES TO AVOIDANCE BY THE DEBTOR’S BANKRUPTCY TRUSTEE

Before D’s bankruptcy trustee may avoid a transfer of debtor property under Section 547(b), the affected creditor will have a chance to show that **the transfer can be defended** on one of the grounds specified in Section 547(c). For our purposes, you might consider the Section 547(c) defenses as falling into one of two camps. Either, the defense is trying to overcome a harsh result caused by one of Section 547’s timing rules governing transfers (transfer occurs upon perfection rather than attachment, transfer occurs only



Your textbook does not really discuss the earmarking doctrine. Notice, however, the logic of it. We know that a transfer of debtor property may result in a preference. If we have a transfer that we do not want to avoid, one solution is simply to ignore the fact that debtor property was transferred. By definitional magic, debtor property becomes something else--earmarked property that never really was property of the debtor.

Do not worry about being tested on how earmarking can be theorized as a Section 547(c) defense.

⁷ See David Gray Carlson & William H. Widen, The Earmarking Defense to Voidable Preference Liability: A Reconceptualization, 73 Am. Bankr. L. J. 591 (Summer 1999).

when debtor acquires rights in the collateral) or the defense is trying to prevent various degrees of commercial chaos and transaction costs that would be caused or incurred if D's bankruptcy trustee were allowed to recover certain kinds of ordinary payments not likely made under duress, coercion or for reasons of favoritism.

Suppose that D is a business enterprise. Each month, D will make payments to its suppliers of goods and services.⁸ In a typical case, a supplier delivers goods to D at time T1, together with an invoice dated T1 listing the items delivered at T1. D reviews the actual delivery against the list in the invoice and signs the invoice to indicate its receipt of the items listed. The invoice states that payment is due not later than some future date, T2 (assume 30 days after the date of the invoice). The invoice may create a financial incentive for D to pay substantially in advance of T2 by offering a discount for early payment.⁹ The obligation that D owes to the supplier is incurred at T1. Sometimes this extension of credit by the supplier is referred to as "trade" credit.

Each month, D pays its suppliers of goods and services; you might think about payments for utilities, telephone bills, gardening services, and suppliers of products used or consumed as D runs its business. Each payment at T2 of a debt incurred at T1 is a payment in respect of an antecedent debt—the trade credit incurred by D. These costs are incurred fairly regularly, and D makes fairly predictable regular payments, regardless of whether D is financially sound or hovering near the edge of bankruptcy. So long as D does not change its payment pattern with respect to these types of vendors, there is little concern that D was coerced to make a payment or that D made a payment to prefer one unsecured vendor over another. In this case, Section 547(c)(2) provides a three part test to protect such payments from recovery as preferential transfers. The test is designed to make sure that coercion and favoritism did not play any role in the payment by D. The test also requires that the payment be made "according to ordinary business terms."¹⁰

Suppose that D purchases equipment from a vendor ("C") using purchase money financing at time T1. If this financing is secured by a PMSI, under UCC Section 9-324(a), C has 20 days to file a financing

⁸ Also, D will make rent payments to its landlord. However, rent typically is paid in advance, not in arrears. Further, a landlord typically holds a deposit equal to one or two months rent. Thus, rental payments are not payments in respect of an antecedent debt for prior use of the property and, in any event, likely would have been secured by the deposit.

⁹ A typical business term would be "2% 10, net 30" which means that a 2% discount is offered off the invoice amount if payment is made within 10 days of the invoice but that, in any event, payment in full must be made within 30 days of the invoice.

¹⁰ See *Matter of Tolona Pizza Products Corp.*, 3 F. 2d 1029 (7th Cir. 1993)(Posner, J.)(**TEXT 595**).

It is useful to know what "trade" credit is. Sometimes, lawyers refer to the trade creditors simply as "the trade." For example, a bankruptcy lawyer may express the opinion that a debtor will not be able to be successfully reorganized unless the senior creditors "take care of the trade."

statement and still have its purchase money priority defeat other previously filed financing statements. Further, under UCC Section 9-317(e), a 20-day grace period is provided to protect PMSI's against lien creditors. Suppose that C files its financing statement at time T2 (say, 15 days after delivery of the equipment) to take advantage of these 20 day grace periods. Under Code Section 547(c)(3), C has a defense to any allegation that the delayed perfection resulted in a preference. This defense is needed to protect C because, under Section 547(e)(2), the time of perfection of the security interest is deemed to be the time of transfer. The debt was incurred at T1 and the transfer of the security interest occurred at T2, when the interest was perfected. Thus, on its face, we have a transfer in respect of antecedent debt.¹¹

Just as in the case of earmarking where judges used some odd definitions, lawyers and judges will adjust the ordinary meaning of "substantially contemporaneous" to achieve a particular substantive result.

If, however, applicable state law purports to give C a grace period that exceeds 20 days (say, 30 days) to file its necessary paperwork for a PMSI (such as exists in some states for automobiles), and C files its paperwork within that extended grace period (say, on day 25), does C get to take advantage of the PMSI protection given by Section 547(c)(3)? The answer is NO!¹² Instead, C might try to defend under Section 547(c)(1) by arguing that the transfer was intended to be a transfer made as part of a contemporaneous exchange for new value and that, under the circumstances, a filing within 30 days was, in fact, a substantially contemporaneous exchange.¹³

Suppose that D owns a pool of receivables at time T1 that has a value of \$1 million. At time T2 (say, 90 days later) D also owns a pool of receivables with a value of \$1 million. However, all of the individual receivables outstanding at T1 have been paid prior to T2 so that the entire pool of receivables owned by D at T2 consists of newly generated receivables acquired by D within the 90-day preference period prior to any potential bankruptcy filing by D. This would be true, for example, if D required all of its customers to make payments on invoices within thirty days from the date of invoice.

Suppose that C decides to loan D \$800,000 based on the value of its pool of receivables. As old receivables are collected, new receivables are generated. As these new receivables come into existence, they would



¹¹ It is unclear under Section 547(e)(2)(A) whether C can argue that there was no transfer in respect of antecedent debt because a 20 day period is substituted for a 10 day period or whether, instead, this subsection is not intended to apply to PMSI's. The latter interpretation forces C to rely on the Section 547(c)(3) defense rather than the timing rule.

¹² See *Fidelity Financial Services, Inc. v. Fink*, 118 S. Ct. 651 (1998)(**TEXT 616**).

¹³ See *Pine Top Ins. Co. v. Bank of America Nat. Trust & Sav. Assoc.*, 969 F. 2d 321 (7th Cir. 1992)(**TEXT 591**)(discussing factors to analyze temporal proximity needed to find a contemporaneous exchange in fact).

become subject to a security interest created by a security agreement with an after acquired property clause. Assuming an even flow of business conducted by D, C is always secured by collateral with a value of approximately \$800,000. Nevertheless, without Section 547(c)(5), C's entire security interest in the pool of receivables would be avoidable as a preference because the entire pool of receivables consists of collateral acquired by D during the preference period. C's position is improved from where it would have been if C had not had the benefit of this after acquired collateral.

Section 547(c)(5) creates an improvement in position test. Suppose that C loaned D \$800,000 secured by a pool of receivables and that this receivables pool had a value of \$600,000 at time T1. At T1 plus 90 days, D's pool of receivables has a value of \$900,000. Assume that the pool is comprised of all new receivables at T1 plus 90 (*i.e.* all receivables in existence at T1 have been collected or written off). D files for bankruptcy at T1 plus 90. Even though all the receivables in the pool at T1 plus 90 constitute after acquired property acquired by D during the preference period, Section 547(c)(5) defends the security interest of C in this pool except to the extent that C improved its position. Since C was undersecured at time T1 and was fully secured at time T1 plus 90, C's security interest in receivables will be reduced to \$600,000.

Contrast this case with one in which the receivables pool had values of \$1 million at T1, \$500,000 at T1 plus 45 days and \$1 million at T1 plus 90 days. In this case, C did experience an improvement in position. However, if we use only two points of reference to measure improvement in position, there has been no change. For administrative convenience, the test of Section 547(c)(5) only examines two points in time. Thus, considered in isolation, there has been no improvement in position so the trustee may not avoid any of C's security interest in the receivables pool.

A similar analysis applies in the case of a pool of inventory. Suppose that C loaned D \$800,000 secured by inventory valued at approximately \$1 million. However, note that in the case of inventory, we can construct an example in which an improvement in position occurs based on a transfer of new inventory even though the collateral values of the two pools remain the same. Suppose that at time T1 D has an inventory pool valued at \$1 million. Also, suppose that this inventory consists of 1 million widgets. Now, if the value of these widgets declines to \$500,000 by time T1 plus 90 days and none of the existing widgets owned by D at T1 has been sold, we see that the position of C has improved by the acquisition of new inventory. (The failure to sell may be why the widgets declined in value!) In any case, at T1 plus 45 days, D acquires a shipment of super widgets valued at

\$500,000. Though the value of the pool of inventory at T1 and at T1 plus 90 days remains the same, \$1 million on each date, there has been a transfer of D's property to C that improved C's position. This transfer may be avoided as a preferential transfer even though the value of the pools of inventory as of the two dates has remained constant.

It is possible to create preferences by supplying a letter of credit to support an antecedent debt if the reimbursement obligation owed to the issuer of the letter of credit is secured by property of D but the obligation owed to C that benefits from the issuance of the letter of credit is unsecured.¹⁴

In the simplest case, assume C loans D \$1000 at time T1 on an unsecured basis. Two years later, at time T2, C demands that D give it a letter of credit to support repayment of this loan. D contacts a bank that agrees to issue letters of credit for the account of D ("LC"). LC agrees to issue a letter of credit to C provided that D grants a security interest in D's property to secured reimbursement of LC for any draws on the letter of credit made by C. D grants the security interest to LC at time T3 and, also at time T3, LC issues the letter of credit to C. D files for bankruptcy at time T4. Now, if T4 occurs less than 90 days after T3, we might argue that the transfer of security made by D to LC was also a transfer for the benefit of C. Thus, although LC might argue that it simultaneously extended credit to D and received its security interest, the bankruptcy trustee may use the benefit to C in respect of antecedent debt to find a preference. As we have seen, the trustee has the option of recovering from either C or LC, unless a defense can be made.



HOW DOES THE STATUTE GIVE US THE RESULTS DISCUSSED ABOVE?

Set forth below is an annotation of various statutory sections designed to illustrate how the analysis discussed above is gleaned from the Code and the UCC.

The Bankruptcy Code

Sec. 101. Definitions

In this title -

(5) "claim" means -

* * *

NB: This is what creditors have within the meaning of the Code.

¹⁴ See *Matter of Compton Corp.*, 831 F. 2d 586 (5th Cir. 1987)(**TEXT 692**). See also David Gray Carlson & William H. Widen, *Letters of Credit, Voidable Preferences and the "Independence" Principle*, 54 *Bus. L. Rev.* 1661 (August 1999)(explaining *Compton* and other cases).

(A) right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, **contingent**, matured, unmatured, disputed, undisputed, legal, equitable, **secured**, or **unsecured**; or

(B) right to an equitable remedy for breach of performance if such breach gives rise to a right to payment, whether or not such right to an equitable remedy is reduced to judgment, fixed, contingent, matured, unmatured, disputed, undisputed, secured, or unsecured;

* * *

(10) "**creditor**" means -

(A) **entity that has a claim** against the debtor that arose at the time of or before the order for relief concerning the debtor;

(B) entity that has a claim against the estate of a kind specified in section 348(d), 502(f), 502(g), 502(h) or 502(i) of this title; or

(C) entity that has a community claim;

* * *

(31) "**insider**" includes -

(A) if the debtor is an individual -

(i) relative of the debtor or of a general partner of the debtor;

(ii) partnership in which the debtor is a general partner;

(iii) general partner of the debtor; or

(iv) corporation of which the debtor is a director, officer, or person in control;

(B) **if the debtor is a corporation** -

(i) **director** of the debtor;

(ii) **officer** of the debtor;

(iii) **person in control** of the debtor;

(iv) partnership in which the debtor is a general partner;

(v) general partner of the debtor; or

(vi) relative of a general partner, director, officer, or person in control of the debtor;

(C) if the debtor is a partnership -

(i) general partner in the debtor;

(ii) relative of a general partner in, general partner of, or person in control of the debtor;

(iii) partnership in which the debtor is a general partner;

(iv) general partner of the debtor; or

(v) person in control of the debtor;

(D) if the debtor is a municipality, elected official of the debtor or relative of an elected official of the debtor;

The definition of insider is complicated and varies by type of entity. For example, you might focus on the case of a debtor that is a corporation. It is transfers to or for the benefit of an insider that are subject to a one year preference period.

Note the general rule that claims are the sort of thing that arise before the bankruptcy filing.

- (E) affiliate, or insider of an affiliate as if such affiliate were the debtor; and
- (F) managing agent of the debtor;

* * *

(54) **"transfer"** means **every mode**, direct or indirect, **absolute or conditional**, voluntary or involuntary, of disposing of or parting with property or with an interest in property, **including retention of title as a security interest** and foreclosure of the debtor's equity of redemption;

The broad definition of transfer that is the first key term to understand if you want to decipher preferences.

Sec. 547. Preferences

(a) In this section -

- (1) "inventory" means personal property leased or furnished, held for sale or lease, or to be furnished under a contract for service, raw materials, work in process, or materials used or consumed in a business, including farm products such as crops or livestock, held for sale or lease;
- (2) "new value" means money or money's worth in goods, services, or new credit, or release by a transferee of property previously transferred to such transferee in a transaction that is neither void nor voidable by the debtor or the trustee under any applicable law, including proceeds of such property, but does not include an obligation substituted for an existing obligation;
- (3) "receivable" means right to payment, whether or not such right has been earned by performance; and
- (4) a debt for a tax is incurred on the day when such tax is last payable without penalty, including any extension.



It would be a shame to make a debt for a tax arise too early, now, wouldn't it? That might make payments of taxes preferences, and the government would not want that to happen!

Here are your defenses to preferences.

(b) **Except as provided in subsection (c) of this section, the trustee may avoid any transfer of an interest of the debtor in property -**

- (1) to or for the benefit of a creditor;
- (2) for or on account of an antecedent debt owed by the debtor before such transfer was made;
- (3) made while the debtor was insolvent;
- (4) made -
 - (A) on or within 90 days before the date of the filing of the petition;
 - or
 - (B) between ninety days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider; and
- (5) that enables such creditor to receive more than such creditor would receive if -
 - (A) the case were a case under chapter 7 of this title;



Most creditors

Insiders

There follows the definition of a preference. To see the logic of the statute, the "and" logic is indicated in a yellow highlight and the "or" logic is indicated in a light blue or green highlight. When reading any statute, you must pay attention to these types of logical connectives in order to understand the section. It is also good to keep track of "except," "only if" and other words of similar import. Also, you should pay attention to any timing words, such as "before," "after," "prior to," etc.

Now we begin the defenses.

Continuation of the hypothetical liquidation test.

(B) the transfer had not been made; and
(C) such creditor received payment of such debt to the extent provided by the provisions of this title.

(c) **The trustee may not avoid under this section a transfer -**

(1) to the extent that such transfer was -

(A) intended by the debtor and the creditor to or for whose benefit such transfer was made to be a contemporaneous exchange for new value given to the debtor; and

(B) in fact a substantially contemporaneous exchange;

(2) to the extent that such transfer was -

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

(B) made in the ordinary course of business or financial affairs of the debtor and the transferee; and

(C) made according to ordinary business terms;

(3) that creates a security interest in property acquired by the debtor -

(A) to the extent such security interest secures new value that was -

(i) given at or after the signing of a security agreement that contains a description of such property as collateral;

(ii) given by or on behalf of the secured party under such agreement;

(iii) given to enable the debtor to acquire such property;

and

(iv) in fact used by the debtor to acquire such property;

and

(B) that is perfected on or before 20 days after the debtor receives possession of such property;

(4) to or for the benefit of a creditor, to the extent that, after such transfer, such creditor gave new value to or for the benefit of the debtor -

(A) not secured by an otherwise unavoidable security interest; and

(B) on account of which new value the debtor did not make an otherwise unavoidable transfer to or for the benefit of such creditor;

(5) that creates a perfected security interest in inventory or a receivable or the proceeds of either, except to the extent that

the aggregate of all such transfers to the transferee caused a reduction, as of the date of the filing of the petition and to the prejudice of other creditors holding unsecured claims, of any amount by which the debt secured by such security interest

The contemporaneous exchange defense.

The ordinary course of business defense.

The purchase money defense.

The inventory and receivables financing defense.

The new value defense.

exceeded the value of all security interests for such debt **on the later of -**

Regular creditors.

(A)(i) with respect to a transfer to which subsection (b)(4)(A) of this section applies, 90 days before the date of the filing of the petition; **or**

Insiders.

(ii) with respect to a transfer to which subsection (b)(4)(B) of this section applies, one year before the date of the filing of the petition; **or**

(B) the date on which new value was first given under the security agreement creating such security interest;

(6) that is the fixing of a statutory lien that is not avoidable under section 545 of this title;

(7) to the extent such transfer was a bona fide payment of a debt to a spouse, former spouse, or child of the debtor, for alimony to, maintenance for, or support of such spouse or child, in connection with a separation agreement, divorce decree or other order of a court of record, determination made in accordance with State or territorial law by a governmental unit, or property settlement agreement, but not to the extent that such debt -

(A) is assigned to another entity, voluntarily, by operation of law, or otherwise; **or**

(B) includes a liability designated as alimony, maintenance, or support, unless such liability is actually in the nature of alimony, maintenance or support; **or**

(8) if, in a case filed by an individual debtor whose debts are primarily consumer debts, the aggregate value of all property that constitutes or is affected by such transfer is less than \$600.

(d) The trustee may avoid a transfer of an interest in property of the debtor transferred to or for the benefit of a surety to secure reimbursement of such a surety that furnished a bond or other obligation to dissolve a judicial lien that would have been avoidable by the trustee under subsection (b) of this section. The liability of such surety under such bond or obligation shall be discharged to the extent of the value of such property recovered by the trustee or the amount paid to the trustee.

(e)(1) For the purposes of this section -

(A) a transfer of real property **other than fixtures**, but including the interest of a seller or purchaser under a contract for the sale of real property, is perfected when a bona fide purchaser of such property from the debtor against whom applicable law permits such transfer to be perfected cannot acquire an interest that is superior to the interest of the

For new deals that arise during the applicable preference period.



transferee; and

(B) a transfer of a **fixture** or property other than real property is perfected when a creditor on a simple contract cannot acquire a judicial lien that is superior to the interest of the transferee.



This is the exception that says a transfer does not occur until the debtor has rights in the collateral.

(2) For the purposes of this section, **except as provided in paragraph (3) of this subsection**, a transfer is made -

(A) at the time such transfer takes effect between the transferor and the transferee, **if such transfer is perfected at, or within 10 days after, such time, except as provided in**

In the case of a security interest, this time would be the time of attachment under UCC Section 9-203.

subsection (c)(3)(B);

(B) at the time such transfer is perfected, **if such transfer is perfected after such 10 days; or**

(C) immediately before the date of the filing of the petition, **if such transfer is not perfected at the later of -**

(i) the commencement of the case; or

(ii) 10 days after such transfer takes effect between the transferor and the transferee.

In theory, this allows a PMSI acquired prior to a bankruptcy filing to be perfected by filing a UCC after the bankruptcy was commenced. Note that it does not work very well for a 20 day PMSI grace period. Still, under Code Section 362(b) it appears that a full 20 day period may be allowed without violating the automatic stay.

(3) For the purposes of this section, a transfer is not made until the debtor has acquired rights in the property transferred.

(f) For the purposes of this section, the debtor is presumed to have been insolvent on and during the 90 days immediately preceding the date of the filing of the petition.

(g) For the purposes of this section, the trustee has the burden of proving the avoidability of a transfer under subsection (b) of this section, and the creditor or party in interest against whom recovery or avoidance is sought has the burden of proving the nonavoidability of a transfer under subsection (c) of this section.

Sec. 550. Liability of transferee of avoided transfer

(a) Except as otherwise provided in this section, to the extent that a transfer is avoided under section 544, 545, **547**, 548, 549, 553(b), or 724(a) of this title, the trustee may recover, for the benefit of the estate, the property transferred, or, if the court so orders, the value of such property, from -

This is the section that a trustee uses to recover from either the creditor or the guarantors.

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

(2) any immediate or mediate transferee of such initial transferee.

(b) The trustee may **not** recover under section (a)(2) of this section from -

(1) a transferee that takes for value, including satisfaction or securing of a present or antecedent debt, in good faith, and

This does not protect initial transferees!

Nobody is sure what this means. It either creates a 20 grace period for PMSI's or it forces PMSI's to rely on the Code Section 547(c)(3) defense. Both offer 20 day protection.

without knowledge of the voidability of the transfer avoided; or
 (2) any immediate or mediate good faith transferee of such transferee.

(c) If a transfer made between 90 days and one year before the filing of the petition -

- (1) is avoided under section 547(b) of this title; and
- (2) was made **for the benefit of a creditor** that at the time of such transfer was an insider;

the trustee may **not** recover under subsection (a) from a transferee that is not an insider.

(d) The trustee is entitled to only a single satisfaction under subsection (a) of this section.

(e)(1) A good faith transferee from whom the trustee may recover under subsection (a) of this section has a lien on the property recovered to secure the lesser of -

- (A) the cost, to such transferee, of any improvement made after the transfer, less the amount of any profit realized by or accruing to such transferee from such property; and
- (B) any increase in the value of such property as a result of such improvement, of the property transferred.

(2) In this subsection, "improvement" includes -

- (A) physical additions or changes to the property transferred;
- (B) repairs to such property;
- (C) payment of any tax on such property;
- (D) payment of any debt secured by a lien on such property that is superior or equal to the rights of the trustee; and
- (E) preservation of such property.

(f) An action or proceeding under this section may not be commenced after the earlier of -

- (1) one year after the avoidance of the transfer on account of which recovery under this section is sought; or
- (2) the time the case is closed or dismissed.

- Sec. 551. Automatic preservation of avoided transfer
- Any transfer avoided under section 522, 544, 545, **547**, 548, 549, or 724(a) of this title, or any lien void under section 506(d) of this title, is preserved for the benefit of the estate but only with respect to property of the estate.

This is the subsection that is designed to save a bank that receives a guarantee from an insider.

Note that a trustee may not collect twice.

A trustee may avoid a security interest but that does not mean it goes away. The trustee preserves the avoided security interest so that junior creditors do not have their position improved by the avoidance.

The Uniform Commercial Code

Section 9--203. Attachment and Enforceability of Security Interest; Proceeds; Supporting Obligations; Formal Requisites.

Attachment is the time that a security interest becomes enforceable by a creditor against a debtor. This is the moment that it "takes effect" for purposes of Code Section 547(e).

(a) Attachment. A security interest attaches to collateral when it becomes enforceable against the debtor with respect to the collateral, unless an agreement expressly postpones the time of attachment.

(b) Enforceability. Except as otherwise provided in subsections (c) through (i), a security interest is enforceable against the debtor and third parties with respect to the collateral only if: (1) value has been given; (2) the debtor has rights in the collateral or the power to transfer rights in the collateral to a secured party; and (3) one of the following conditions is met: (A) the debtor has authenticated a security agreement that provides a description of the collateral and, if the security interest covers timber to be cut, a description of the land concerned; (B) the collateral is not a certificated security and is in the possession of the secured party under Section 9--313 pursuant to the debtor's security agreement; (C) the collateral is a certificated security in registered form and the security certificate has been delivered to the secured party under Section 8--301 pursuant to the debtor's security agreement; or (D) the collateral is deposit accounts, electronic chattel paper, investment property, or letter-of-credit rights, and the secured party has control under Section 9--104, 9--105, 9--106, or 9--107 pursuant to the debtor's security agreement.

(c) Other UCC provisions. Subsection (b) is subject to Section 4--210 on the security interest of a collecting bank, Section 5--118 on the security interest of a letter-of-credit issuer or nominated person, Section 9--110 on a security interest arising under Article 2 or 2-A, and Section 9--206 on security interests in investment property.

(d) When a person becomes bound by another person's security agreement. A person becomes bound as debtor by a security agreement entered into by another person if, by operation of law other than this article or by contract: (1) the security agreement becomes effective to create a security interest in the person's property; or (2) the person becomes generally obligated for the obligations of the other person, including the obligation secured under the security agreement, and acquires or succeeds to all or substantially all of the assets of the other person.

(e) Effect of new debtor becoming bound. If a new debtor becomes bound as debtor by a security agreement entered into by another person: (1) the agreement satisfies subsection (b)(3) with respect to existing or after-acquired property of the new debtor to the extent the property is described in the agreement; and (2) another agreement is not necessary to make a security interest in the property enforceable.

(f) Proceeds and supporting obligations. The attachment of a security interest in collateral gives the secured party the rights to proceeds provided by Section 9--315 and is also attachment of a security interest in a supporting obligation for the collateral.

(g) Lien securing right to payment. The attachment of a security interest in a right to payment or performance secured by a security interest or other lien on

personal or real property is also attachment of a security interest in the security interest, mortgage, or other lien.

(h) Security entitlement carried in securities account. The attachment of a security interest in a securities account is also attachment of a security interest in the security entitlements carried in the securities account.

(i) Commodity contracts carried in commodity account. The attachment of a security interest in a commodity account is also attachment of a security interest in the commodity contracts carried in the commodity account.

Section 9--204. After-acquired Property; Future Advances.

(a) After-acquired collateral. Except as otherwise provided in subsection (b), a security agreement may create or provide for a security interest in after-acquired collateral.

(b) When after-acquired property clause not effective. A security interest does not attach under a term constituting an after-acquired property clause to: (1) consumer goods, other than an accession when given as additional security, unless the debtor acquires rights in them within 10 days after the secured party gives value; or (2) a commercial tort claim.

(c) Future advances and other value. A security agreement may provide that collateral secures, or that accounts, chattel paper, payment intangibles, or promissory notes are sold in connection with, future advances or other value, whether or not the advances or value are given

Among other things, this is the clause that makes a revolving line of credit secured by inventory or receivables work. As new inventory or receivables are generated, the security agreement may provide that the new assets provide collateral. Further, the bank or other lender may make advances from time to time and those advances will be secured, again, only if the security agreement so provides.

If a court determines that, as a matter of contract law, your security agreement did not so provide, then you are out of luck. If you are in luck, then you may use the Code Section 547(c)(5) defense to protect your financing.

April 2003, Coral Gables, Florida