In Defense of the Bankruptcy Code's Radical Integration of the Preference Rules Affecting Commercial Financing

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IN DEFENSE OF THE BANKRUPTCY CODE'S RADICAL INTEGRATION OF THE PREFERENCE RULES AFFECTING COMMERCIAL FINANCING

THOMAS M. WARD*
JAY A. SHULMAN**

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I. INTRODUCTION

A. Purpose

The passage of the Bankruptcy Reform Act of 1978 significantly changed the statutory foundation of American preference law.\(^1\) Section 547 mixes new, carefully measured concepts with familiar definitional language from old section 60. The new conceptual structure of section 547 is a departure from the abstract framework of its predecessor. Under section 60, "worthy" transfers were protected by qualifications imaginatively grafted by the judges onto the specific elements of the preference definition. Among the most ingenious, and perhaps most significant, of these qualifications were those designed to protect pre-petition transfers incident to various types of financing arrangements. In contrast, section 547 of the Bankruptcy Code (Code) is a new and radical integration of definition and exception. The exceptions are separately listed in the statute and are not codifications of old case law qualifications. The new statutory test clearly displaces the old approach to "worthy" transfers. The use of section 60 language in the 547(b) definition of a preference, however, makes the vitality of old case law qualifications of this language an open question. The role of this case law in the new integration is a general concern that runs throughout the following discussion. Another general concern is the mechanics of the new integration when transfers normally incident to commercial financing are involved. What is the proper relationship between definition and exception in the new integration? How do the separate exceptions which may affect commercial financing relate to one another? Although the language of each exception suggests an isolated application, in a typical commercial financing arrangement several ex-

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Section 401(a) of the Bankruptcy Reform Act repealed the prior Bankruptcy Act. Pub. L. No. 95-598, tit. IV, §§ 401(a), 402(a), 92 Stat. 2682 (1978). For most substantive purposes, the repeal was effective on October 1, 1979. The "Bankruptcy Act" is the common name given to "An Act to Establish a Uniform System of Bankruptcy throughout the United States." Act of July 1, 1898, ch. 541, 30 Stat. 544 (repealed 1978). For comparison purposes, the most important sections of the "Act" were § 60 (Preferred Creditors) and § 1 (Meaning of Words and Phrases). The words "Bankruptcy Act" or "Act," when used in this Article, refer to the statutory provisions of the 1898 Act that were repealed in 1978. Pub. L. No. 95-598, tit. IV, § 401(a), 92 Stat. 2682 (1978). The words "Bankruptcy Code" and "Code" are used in this Article to refer to the current provisions enacted by the Bankruptcy Reform Act of 1978. 11 U.S.C. §§ 101 to 151326 (Supp. V 1981) (amending 11 U.S.C. §§ 101 to 1255 (1976 & Supp. II 1978)).
exceptions may be brought into play. This Article systematically examines the many specific problems within these broad topic areas in an effort to provide helpful solutions. Before these problems are discussed in more detail, however, some background is needed to give perspective to the new integration.

B. Background

Preference law has always had an intriguing structure. Its foundation has always been legislative, but its shape and detail historically have been fashioned by case law. Between 1898 and 1978, when the new Code was enacted, section 60 of the Bankruptcy Act was the statutory foundation for preference law. From the beginning, section 60 was highly conceptual, lacking a specific list of either included or ex-

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2. The first American bankruptcy statute was the Bankruptcy Act of 1800, ch. 9, 2 Stat. 19 (repealed 1803). It copied existing English laws and therefore contained no mention of preferences. Neither, however, did this first statute specifically save bona fide payments in the ordinary course which were protected under existing English law. Despite the absence of a statutory base, case law developed in the early part of the nineteenth century which proscribed certain preferential transfers as “fraudulent.” See, e.g., Locke v. Winning, 3 Mass. 324 (1807).

A statutory definition of preference first appeared in the Bankruptcy Act of 1841, ch. 9, § 2, 5 Stat. 440 (repealed 1843). The preference, treated in the manner of a fraudulent conveyance, was an “act of bankruptcy.” The elements of this first statutory definition included the requirements that bankruptcy be contemplated and that the debtor intend to prefer or give priority. The case law under the 1841 Act, however, emphasized presumed intention derived from the financial position of the debtor before and after the transfer, rather than the actual purpose of the transfer. See, e.g., Everett v. Stone, 8 F. Cas. 898 (C.C.D. Me. 1844) (No. 4577); Peckham v. Burrows, 19 F. Cas. 85 (C.C.D. R.I. 1844) (No. 10,897); Arnold v. Maynard, 1 F. Cas. 1181 (C.C.D. Mass. 1842) (No. 561).

Influenced by prior case law, the Bankruptcy Act of 1898 moved away from fraudulent purpose and adopted the familiar but highly theoretical framework of section 60. For the case law oriented history of preference law before the 1898 Act, see In re Hall, 4 Am. Bankr. R. 671, 679-88 (W.D.N.Y. 1900). Section 60 itself has been little more than a foundation for a case law exposition of the various elements. See McCoid, Bankruptcy, Preferences, and Efficiency: An Expression of Doubt, 67 VA. L. REV. 249, 249-59 (1981).

3. Section 60 was amended six times prior to its ultimate repeal by the Bankruptcy Reform Act. The amendments of 1903, 1910, and 1926 were aimed at strengthening the law against secured creditors who attempted to appropriate the debtor’s assets on the eve of bankruptcy. See J. MACLACHLAN, BANKRUPTCY § 257 (1956). The amendments of 1938 took a more significant step in that same direction, The Chandler Act, Act of June 22, 1938, ch. 575, 52 Stat. 940 (1938). The Chandler Act provided that the trustee could claim the standing of a bona fide purchaser against transfers “unperfected” at bankruptcy. It further provided that transfers “perfected” before the petition were “deemed” made when so “perfected.” The 1950 amendments modified the Chandler Act by specifying that transfers of personalty were deemed made when they were so far perfected that no “lien . . . attainable by legal or equitable proceedings . . . could become supe-
cluded transfers. 4 Section 60 case law soon developed a life of its own, nearly independent of the language of the section. 5

Independent expansion of these protective case law concepts was both natural and predictable. Expanding credit requirements in the late nineteenth and early twentieth centuries led to the development of security arrangements which extended the notion of collateral to include replacements and additions acquired after the original understanding. 6 When the debtor's assets were by nature constantly turning

4. The Act of July 1, 1898, ch. 541, 30 Stat. 562 provided:
Sec. 60 Preferred Creditors.
  a A person shall be deemed to have given a preference if, being insolvent, he has procured or suffered a judgment to be entered against himself in favor of any person, or made a transfer of any of his property, and the effect of the enforcement of such judgment or transfer will be to enable any one of his creditors to obtain a greater percentage of his debt than any other of such creditors of the same class.
  b If a bankrupt shall have given a preference within four months before the filing of a petition, or after the filing of the petition and before the adjudication, and the person receiving it, or to be benefited thereby, or his agent acting therein, shall have had reasonable cause to believe that it was intended thereby to give a preference, it shall be voidable by the trustee, and he may recover the property or its value from such person.
  c If a creditor has been preferred, and afterwards in good faith gives the debtor further credit without security of any kind for property which becomes a part of the debtor's estates, the amount of such new credit remaining unpaid at the time of the adjudication in bankruptcy may be set off against the amount which would otherwise be recoverable from him.


5. See, e.g., Pirie v. Chicago Title & Trust Co., 182 U.S. 438 (1901); Kimball v. E.A. Rosenham Co., 114 F. 85 (8th Cir. 1902); C.S. Morey Mercantile Co. v. Schiffer, 114 F. 447 (8th Cir. 1902); Gans v. Ellison, 114 F. 734 (3d Cir. 1902); Dickson v. Wyman, 111 F. 726 (1st Cir. 1901); McKey v. Lee, 105 F. 923 (7th Cir. 1901). See infra text accompanying notes 161-75. Later decisions dating the time of transfer served to protect the floating lien and other collateral transfers incident to after-acquired property financing. See, e.g., In re Portland Newspaper Publishing Co., 271 F. Supp. 395 (D. Or. 1967), aff'd sub nom. DuBay v. Williams, 417 F.2d 1277 (9th Cir. 1969); Grain Merchants v. Union Bank & Sav. Co., 408 F.2d 209 (7th Cir. 1969). See also Skilton, Security Interests in After-Acquired Property Under the Uniform Commercial Code, 1974 Wis. L. REV. 925, 970-86.

over, as in the case of accounts or inventory, this extension was often critical. 7

The circumstances which prompted the development of an extended concept of security encouraged the fashioning of a flexible debt obligation geared to inevitable fluctuations in the value of the collateral. A regular sequence of advances and payments became common within the context of secured financing, whether the debtor's collateral was by nature constantly shifting or merely subject to occasional expansion and substitution. At the time these arrangements became important, the language of section 60 did not provide a specific foundation for their protection. 8 Nevertheless, section 60, along with its case law corollaries, might have worked adequately if the hodgepodge structure of American security law had not changed. In 1950, when old section 60 was last amended, radical surgery on security law was, however, already underway. The structure and terminology of the Uniform Commercial Code (UCC) ushered in a new approach to familiar financing devices. After-acquired property financing and a running account concept of credit fell within a new set of facilitating rules. Unfortunately, the terminology and structure of financing under Article 9 of the UCC was foreign to the language of section 60. Cases attempting reconciliation of the two laws produced one-sided solutions and bent the language of both statutes almost to the breaking point. A committee of the National Bankruptcy Conference charged with exploring a coordination of the statutes reported: "[P]rospects for working through to an intermediate position . . . through a case law development do not appear to be particularly bright. If a fair and sensible resolution of the underlying policy issues is available, . . . a statutory revision is indicated. . . ." 9 This suggested legislative coordination was absorbed

7. For accounting purposes, inventories and receivables are often lumped along with cash in the "current assets" classification. T. FIFLES & H. KRIPE, ACCOUNTING FOR BUSINESS LAWYERS 56 (1971). Although liquid, these assets are not ephemeral. The investment of a business enterprise in a standing inventory is a long term relatively fixed investment. Similarly, the credit investment in receivables normally fluctuates only within defined limits. Long term capital is required to sustain both of these investments. Kripke, Current Assets Financing as a Source of Long-Term Capital, 36 MINN. L. REV. 506, 510-12 (1952).


9. NATIONAL BANKRUPTCY CONFERENCE, REPORT OF COMMITTEE ON COORDINATION OF
into the general revision of bankruptcy law and procedure begun in 1968. Between the formation of the Commission to Study the Bankruptcy Laws of the United States and the final passage of the Bankruptcy Reform Act of 1978, several revisions of the preference section were proposed. The study of the step-by-step development of the preference section from early proposals to its present form reveals far more about congressional intent than does the more visible legislative history. As noted at the outset, the statute that finally emerged, de-


H.R. 8200 and S. 2266 were the last stages of a legislative process formally begun in 1970 with the establishment of a Commission on the Bankruptcy Laws of the United States. See supra note 10. Part 2 of the Commission's Report was a proposed new Bankruptcy Act. See supra note 8. The Commission's bill was introduced in the 93d Congress as H.R. 10792 and S. 2565. An alternative proposal was drafted by the National Conference of Bankruptcy Judges and introduced as H.R. 16643 in the 93d Congress. Both the Commission Bill and the Judges' Bill were reintroduced in the 94th Congress as H.R. 31 (S. 236) and H.R. 32 (S. 235). Both the House and Senate held hearings on the bills between February, 1975 and May, 1976.

As a result of these hearings a bill which attempted a synthesis was drafted and introduced in the 95th Congress on January 4, 1977 as H.R. 6. This bill was marked up by the House Subcommittee on Civil and Constitutional Rights of the Committee on the Judiciary. C. Butler, Minutes of the House Subcommittee on Civil and Constitutional Rights of the House Comm. on the Judiciary on H.R. 6, Bankruptcy Law Revision, 95th Cong., 1st Sess. (1977)
spite the reenactment of key phrases from section 60, differed radically in both structure and content from its predecessor. In opting for a list of protected preferential transfers, Congress abandoned earlier attempts to include exceptions by tinkering with the definition of a preference. Congress did not adopt a totally new vocabulary to define a preference in section 547(b), realizing perhaps that some of the section 60 wisdom was still valuable. It must be emphasized, however, that Congress did not intend to integrate two sets of exceptions, one derived from the statutory list in section 547(c), the other from section 60 case law. The applicability of these old decisions creates doubt and confusion concerning the scope of the new preference definition. Both the history and design of section 547 indicate that the section 547(c) exceptions cannot meaningfully be applied until after a section 547(b) preference is found. A radical integration of the two subsections is called for.

C. The Radical Integration—Some Discouraging Signs

The new structure should herald a tighter, more literal construction of the familiar definitional language in section 547(b). In addition, new facilitating rules need to be developed for section 547(c). Early cases are not encouraging. They suggest that protective and ambiguous case law concepts borrowed from section 60 are still being used to shelter transfers not specifically excepted in section 547(c). Also, the relationship between the various exceptions in section 547(c) apparently is not well understood. If these early cases suggest a trend, the result could be a preference law so oblique, cumbersome, and inefficient that it is no longer worth the cost and effort of its administration.

Signs on the legislative front are also discouraging. A creditor-backed challenge to the new structure had significant support in the second session of the Ninety-Seventh Congress. On May 27, 1982 a Senate committee favorably reported on Senate bill S. 2000 which would inject the old “reasonable cause to believe” requirement back into the new section 547 structure. This and other proposed substan-

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13. See infra text accompanying notes 40-75.
14. See supra note 24 for the elements of a § 60 preference. S. Rep. No. 446, 97th Cong., 2d
tive changes to the new Code will almost certainly be reintroduced in the Ninety-Eighth Congress. While minor problems do exist in the new structure, the legislative response recommended in the committee report on S. 2000 is overkill. If the Ninety-Eighth Congress enacts the change recommended in S. 2000 it will strike a crippling blow to the equality principle so central to the new structure. The potentially more efficient structure of section 547 will be undermined before it has a chance to prove itself. 15 If the new structure does not survive these

Sess. (1982). The most controversial provisions of S. 2000 dealt with restrictions on the availability of discharge in consumer bankruptcies. These proposed changes became entangled in the dispute on how to deal with the Supreme Court's decision in Northern Pipeline Constr. Co. v. Marathon Pipe Line Co., 102 S. Ct. 2858 (1982). Supporters of S. 2000 wished to append these substantive changes to the bills which dealt with the jurisdiction question. The House Judiciary Committee insisted on and approved a "clean" jurisdiction bill, H.R. 6978. H. REP. No. 807, 97th Cong., 2d Sess. (1982). Representative Butler introduced two bills, H.R. 7294 and H.R. 7349, which were intended as compromises. These bills contained less severe restrictions on consumer bankruptcies. The latter bill contained an amendment to the preference section which would have contained a "small amount" exception, suggested by the consumer credit industry, whereby the trustee could not avoid aggregate transfers to a particular creditor of less than $1000. No action was taken on these bills, and the 97th Congress adjourned sine die without taking any final action on any bills dealing with the jurisdiction issue or the substantive consumer bankruptcy amendments.

15. The hearings on S. 2000 indicate that early experience with the new act pointed out three minor problems. First, many ordinary course payments on consumer obligations did not qualify for the protection under § 547(c)(2) and recovery of these relatively small amounts did not significantly increase the distributable estate. Bankruptcy Reform Act of 1981: Hearings Before the Subcomm. on Courts of the Senate Comm. on the Judiciary, 97th Cong., 1st Sess. 68-69 (statement of Jonathan M. Landers, Claude Rice & Alvin O. Wiese, Jr.), 158 (statement on behalf of American Retail Federation and National Retail Merchants Ass'n), 181-82 (statement of Fred M. Haden, NAFCU), 249-51 (preliminary report of the Committee on the Avoiding Powers of the National Bankruptcy Conference), 244-45 (testimony of Leonard Rosen), 254-55 (statement of Irving Sulmeyer) (1981) [hereinafter cited as 1981 Reform Act Hearings]. Second, § 547(c)(2) did not adequately protect a few ordinary course commercial credit arrangements. Id. at 244-45 (testimony of Leonard Rosen); id. at 254-55, (testimony of Irving Sulmeyer). Third, a mechanical use of § 547 by the trustee in a Chapter 11 reorganization often defeated the overall purpose of the reorganization. Id. at 249-50. The advocates for reform who addressed these minor problems all stopped short of recommending that "reasonable cause to believe" be restored as a § 547(b) element. The National Bankruptcy Conference explicitly recommended against such a change. Id. at 249. The only consistent advocate of this drastic across the board alteration of the new structure was the American Bankers Association. Id. at 150 (statement of Walter W. Vaughan, American Bankers Ass'n). This position, however, cannot fairly be regarded as a new criticism of § 547 because the American Bankers Association vigorously opposed the elimination of this element when the section was drafted. See Bankruptcy Reform Act of 1978: Hearings Before the Subcomm. on Improvements in Judicial Mach. of the Senate Comm. on the Judiciary, 95th Cong., 1st Sess. 576 (1977). But see Fortgang & King, The 1978 Bankruptcy Code: Some Wrong Policy Decisions, 56 N.Y.U.L. REV. 1148, 1167 (1981).

The change recommended in S. 2000 seems poorly conceived. It inadvertently changes even old
PREFERENCE RULES

attempts by creditors to undermine it by legislation or judicial construction, the preference concept might just as well be eliminated from bankruptcy law altogether. 16

As an alternative to the elimination or compromise of the new preference law, a more efficient, mechanical integration of section 547 language is advanced in this Article. Such an integration would emphasize equality of distribution and provide a more efficient system of recapture. Unlike the situation under section 60, transfers subject to recapture could be predicted with greater certainty. The trustee would be discouraged from challenging transfers clearly within protected categories. Where Congress intended recapture, the trustee's evidentiary and economic burdens would be minimized. 17 Many of the premises underlying this integration may seem a radical departure from familiar preference law. These premises, however, are consistent with the structure that Congress chose for its new preference section.

This Article is presented in defense of the new integration of preference law and may serve as a guide to its purpose and operation when the various transfers incident to commercial financing are involved. In particular, security arrangements involving after-acquired property will be scrutinized. The Article has five major sections. First, the new structure of section 547 is introduced. 18 Second, drawing from the legislative history of section 547, the premise is advanced that the new structure of section 547 has displaced much of the haphazard case law

Act law that was left undisturbed by the Code. Section 67(a)(1) of the Bankruptcy Act allowed the trustee to avoid judicial liens arising during the critical period whether or not the creditor-lienor had “reasonable cause to believe that the debtor was insolvent.” 11 U.S.C. § 67(a)(1) (1976 & Supp. II 1978). One of the consolidations made possible by the elimination of the reasonable cause to believe requirement from § 547 was the elimination of this separate avoidance power. See COMMISSION REPORT (pt. 2), supra note 8, at 172. The substance of the law was not changed because without the “reasonable cause to believe” element § 547 can be used for any recapture in which § 67(a)(1) might have been necessary under the old Act. If S. 2000 passes, judicial liens arising within the ninety-day period will not be avoidable unless the creditor-lienor had “reasonable cause to believe.” There is no reason to make the avoidability of these involuntary lien transfers dependent on the creditor's perception.

The effect of the amendment on the overall structure of new § 547 was not carefully considered. The proposed changes would make much of § 547(c) unnecessary and further complicate application of § 547(c)(5). The more significant damage, however, would be the lost efficiency in preference recapture which was the major reason for the change in the 1978 Code. See infra text accompanying notes 24-39 & note 46.

17. Id. at 262-68.
interpreting the definitional language transplanted from section 60.19
Third, with an eye toward commercial financing arrangements, the in-
tegration of old case law and the new preference definition is carefully
analyzed.20 Fourth, the exceptions in section 547(c) are briefly de-
scribed, and, with the aid of examples, their separate impact and inte-
grated effect on commercial financing is explored.21 Finally, an overall
theory of integration for section 547(b) and all the relevant exceptions
in section 547(c) is described and illustrated by more complex
examples.22

II. THE SUMMARY OF THE NEW STRUCTURE

A. The Important Subsections

As it affects commercial financing, new section 547 has three impor-
tant subsections.23 Subsection (b) lists the elements of a preference.
Subsection (e) contains the rules for determining when a “transfer” oc-
curs in cases where the transferee must comply with state recording,
notice, or documentation requirements in order to get a measure of
protection against third parties. Transfers are preferences if they occur
within the critical period, actually or by virtue of subsection (e), and if
they meet the other requirements of subsection (b). Subsection (c) con-
tains a list of “worthy” preferential transfers which are nonetheless
unavoidable.

19. See infra text accompanying notes 40-75.
20. See infra text accompanying notes 76-236.
22. See infra text accompanying notes 320-46.
23. Three additional subsections within § 547 are significant but will have limited or only
indirect impact on commercial financing. Subsection (a) contains definitions of terms including
“new value” and “receivables.” Subsection (d) deals with transfers to secure reimbursement of a
surety who gives a bond or other obligation for the purpose of dissolving an avoidable judicial
lien. Subsection (f) contains a presumption of insolvency during the 90 days prior to bankruptcy.
See infra note 30.

A proposal for a new section 547(g) was introduced in the Ninety-Seventh Congress as part of
the 1981 Technical Amendments. The purpose of proposed subsection (g) is to expressly allocate
the burdens of proof in § 547. The burdens of proof expressly detailed in proposed subsection (g)
can, however, be inferred from the present structure. The comments accompanying the Technical
Amendments make clear that proposed subsection (g) merely “clarifies” existing law. See S. Rep.
No. 150, 97th Cong., 1st Sess. 11 (1981). The House had previously passed a different version of a
prior Senate bill, containing the same proposed clarification of § 547. See S. 658, 96th Cong., 2d
(1980). Senate bill S. 863 was referred to the House Judiciary Committee but was not acted on
before the end of the session.
B. The Section 547(b) Definition

For the most part, the terms used to state the elements of a preference have been transplanted from section 60 of the old Act. A “transfer” of “property of the debtor” is required. The transfer must be “to or for the benefit of a creditor” and “for or on account of an antecedent debt.”

The transfer must be made while the debtor is insolvent and within the newly defined “critical periods” before bankruptcy. In the case of an ordinary creditor-transferee, the critical pre-petition preference period is shortened from four months to ninety days. If the creditor is an insider, the period is extended to one year. For any transfer within the ninety-day period, whether or not the creditor is an insider, the trustee does not have to prove, as he did under the old Act, that the creditor receiving the preference had “reasonable cause to believe” the debtor was insolvent at the time of transfer. The Code retains the old

24. Briefly, the elements of a preference under section 60 of the Act were: (1) a transfer of the debtor's property, (2) for or on account of an antecedent debt, (3) made within four months of the petition, (4) while the debtor was insolvent, (5) to or for the benefit of the creditor, (6) which transfer enabled the creditor to obtain a greater percentage of his debt than other creditors of the same class. If these elements were present, the trustee could avoid the preference if at the time of the transfer the creditor had “reasonable cause to believe that the debtor was insolvent.”

25. 11 U.S.C. § 547(b) (Supp V 1981). The phrase “property of the debtor” is transplanted from § 60(a) of the Act. “Property of the debtor” is not defined in the Code, but “property of the estate” is described broadly in § 541. Id. § 541. The debtor's exempt property did not become property of the estate under § 70 of the old Act, but under new § 541 all of the debtor's property becomes property of the estate, including exempt property. The fact that transferred property may ultimately be exempted under § 522 does not preclude its recovery by the trustee if the transfer was preferential. If the trustee refuses or neglects to challenge a preferential transfer of debtor's exempt property, the debtor may avoid to the extent that he could have exempted the transferred property under § 522(g)(1). See Id. § 522(h) (Supp. IV 1981).

26. Id. § 547(b)(1), (2) (Supp. IV 1981). Cases dealing with the “for or on account of an antecedent debt” element under § 60 of the Act often struggled to “refine” this phrase in order to protect certain “worthy” transactions. In light of the new relationship between the tightly drawn elements in § 547(b) and the specific exceptions for worthy transactions in subsection (c), these cases should not be carried over into § 547(b). See infra text accompanying notes 40-75.

27. 11 U.S.C. § 547(b)(3),(4) (Supp. IV 1981). Although the trustee must prove the debtor's insolvency, he is now aided by the presumption of § 547(f). See infra note 30.

28. 11 U.S.C. § 547(b)(4)(A), (B) (Supp. IV 1981). “Insider” is defined expansively in § 101(25) to include most of the incidents of blood relationship, management, or control. Id. § 101(25). This definition would include financing agencies which were “affiliates” of the debtor. Id. § 101(2). Between one year and 90 days before bankruptcy, the trustee can only avoid transfers to insiders if he proves they have reasonable cause to believe the debtor is insolvent.

29. A recent Senate proposal seeks to restore the reasonable cause to believe requirement. For a discussion on the damaging impact of such a change on the new § 547 structure, see supra note 15.
Act’s requirement that the debtor be insolvent at the time of transfer. The trustee, however, has the benefit of a presumption that the debtor was insolvent during the ninety days prior to bankruptcy.\textsuperscript{30}

The final requirement in old section 60(a)(1), that the transferee obtain a greater percentage of his debt than “some other creditors of the same class,” has been replaced by a more inclusive and mechanical “receives more” test. Improvement is measured by a simple comparison between liquidation positions. A creditor is preferred if he “receives more” than he would have received \textit{if the transfer had not been made} and the creditor were instead receiving a distribution in a chapter 7 bankruptcy liquidation.\textsuperscript{31}

As a result of these substantive changes, section 547(b) classifies far more transfers as preferences than did section 60(a) of the old Act. These changes are consistent with the overall structure of the new preference scheme because section 547(b) is only the initial step in determining whether transfers are in fact avoidable. Some of these transfers will nonetheless be protected by section 547(c).

\textbf{C. The Timing Rule in Section 547(e)}

New section 547(e) further contributes to the greater inclusiveness of the section 547(b) definition, particularly in cases involving after-acquired property financing. Section 547(e) determines the time of transfer when the transferee must comply with state recording or notice requirements and abandons the “so far perfected” language of section 60(a)(2) by overruling its case law corollaries. Instead, the Code dates the transfer at “perfection” or at the time of actual transfer if perfection occurs within ten days. Perfection is defined with respect to personal property as the time after which a simple contract creditor could not, under state law, obtain a judicial lien prior to the transferee’s interest. Section 547(e)(3), however, prevents the transfer from occurring before the debtor acquires rights in the property being transferred.

Thus, section 547(e) overrules section 60 case law which dated the time of transfer at recording, even if this occurred before the debtor

\textsuperscript{30} 11 U.S.C. § 547(f) (Supp. IV 1981). This presumption shifts the burden of going forward with the evidence on insolvency from the trustee to the creditor-transferee. \textit{See} Fed. R. Evid. 301. Although the trustee shoulders the ultimate burden of proof, unless the creditor comes forward with evidence of solvency, the trustee will prevail on the strength of the presumption.

acquired the property. By postponing the date of transfer, this section helps expand the reach of section 547(b). First, through the abandonment of these artificial devices, more transfers will occur within the critical period. Moreover, the delaying of these transfer dates will make more transfers “for or on account of antecedent debt.”

D. The Exceptions in Section 547(c)

Operating in conjunction with the more inclusive and mechanical sweep of sections 547(b) and 547(e), section 547(c) contains a list of specific exceptions for worthy transfers. But for the mitigating effect of section 547(c), the sweeping efficiencies resulting from the changes in sections 547(b), 547(e), and 547(f) would result in hardship to transferees who are congressionally identified as being engaged in “worthy” ordinary course transactions. At the same time, section 547(c) need be consulted only if a preferential transfer has been established under section 547(b).

The language of section 547(c) is often difficult to navigate, but it is aimed at six different types of “worthy” transfers:

1. Substantially contemporaneous exchanges,
2. Ordinary course payments for “like-cash” obligations incurred in the ordinary course,
3. Enabling loans which are preferences because of section 547(e),
4. Credit against preferential transfers because of subsequent new value given to the debtor,
5. Transfers of floating lien collateral which do not produce a prejudicial improvement of position,

32. For a detailed discussion of the effect of § 547(e)(3), see infra text accompanying notes 81-112.
33. The proposed Technical Amendments expressly allocate the burden of proof between creditor and trustee on the assumption that the elements of § 547(b) must be established by the trustee before the basis for an exception needs to be demonstrated by the creditor. See supra note 23.
The impact of these exceptions on commercial financing, especially those arrangements which rely on after-acquired property, are explored in the balance of this Article. The most important point bearing on the integration of the new preference scheme is developed in the next section. The clear implication from the new structure of the preference section is that section 547(c) contains the exclusive list of exceptions to avoidable preferences. Case law exceptions engrafted into the definitional language of old section 60 should not be injected into the retooled elements of new section 547(b).

III. THE RESPECTIVE ROLES OF SECTIONS 547(b) AND 547(c) IN THE NEW INTEGRATION: LEGISLATIVE HISTORY

A. Preface

Although the new preferences section arms the trustee with a broader definition of a preference, the definition contained in old section 60(a) was itself broad. To temper the breadth of this original definition, the courts developed a body of imaginative, if less than forthright, case law which classified certain transfers as not within the definitional language of section 60. Since section 60 contained no list of protected transfers, this imaginative judicial approach to working and reworking the elements of a preference was the only means of protecting many transfers.

The history of new section 547(c) demonstrates that Congress intended to abandon such devices. Consistent with the case law, initial drafts of the preference section continued to build exceptions into the definitional elements of a preference. The drafters, however, abandoned this approach and ultimately created a new section containing a list of protected transfers. Despite the borrowing of critical phrases from the section 60 definition of a preference, the legislative history taken as a whole indicates that the list of protected transfers in section 547(c) was intended as the exclusive list of exceptions.

Limiting protected transfers to the statutory list is critical to the success of the new preference scheme. The cornerstone of the new preference section is the principle of equality of distribution based on fairness

40. See supra note 4.
41. The enactment of a new statutory structure which relies, in part, on language transplanted from a predecessor statute does not necessarily create a presumption that the enacting legislature adopted the prior construction of the transplanted language. Llewellyn, Remarks on the Theory of Appellate Decision and the Rules or Canons About how Statutes are to be Construed, 3 Vand. L. Rev. 395, 403 (1950). See infra text accompanying notes 68-70.
and perhaps economic utility. Unlike section 60, section 547 does not merely arm the trustee with the power to avoid transfers to creditors who have "behaved badly" by accepting payments with notice of the debtor's insolvency or by participating in the race of diligence. In-
stead, section 547 comes closer to the principle that all creditors ought to be treated equally. Other considerations not tied to the creditor's level of perception nevertheless prevented the adoption of a pure equality rule. Congress protected certain transfers to creditors, simply through a desire to protect and stabilize certain transactions essential to continuation of the business, especially in credit supported enterprises. These protected transfers, however, are similar to each other in another important aspect. Not only has Congress declared these transfers essential, but it has also built in guarantees that the creditor supply the debtor with equivalent value. Both requirements are central to the legislative premise behind the integration of sections 547(b) and 547(c).

The purpose of the new bankruptcy section is to achieve greater fairness by spreading the costs more evenly. This fact is continually obscured by the proponents of the drastic changes in S. 2000. For example, Mr. Norman Grant, Executive Director of the Kansas Retail Council, has described § 547 as “annoying and inequitable. . . .” 1981 Reform Act Hearings, supra note 15, at 158. Permitting certain creditors to keep these payments is “inequitable” and “annoying” to the greater number of unpreferred creditors.

Those objective parties opposed to the drastic legislative assault on the preference scheme have argued to retain the basic equality principle underlying § 547 and to withstand the desires of special creditor interests. One such person has reminded us that: “[t]he equality principle is the most important principle of the preference section. It should be the guiding light, dimmed by protection of ordinary course of business transactions only where necessary.” 1981 Reform Act Hearings, supra note 15, at 302 (statement of Mr. Levin).

44. COMMISSION REPORT (pt. 1), supra note 8, at 219; MARK-UP MINUTES, supra note 12, at 552, 562-63 (Statements of Mr. Klee); 1975 Senate Hearings, supra note 43, at 101-02 (statement of then Bankruptcy Judge Cyr).

45. In § 547(c)(1) an excepted transfer results only where the debtor receives new value in “exchange” for the transfer. In § 547(c)(2) only current “like-cash” ordinary course expenses are excepted. The value given the debtor immediately precedes the ordinary course payments. In § 547(c)(3) collateral transfers are protected when they take place within the context of enabling loans which guarantee that the debtor acquire the new collateral protected. In § 547(c)(4) subsequent new value moving to the debtor can be set off against prior preferential transfers. In § 547(c)(5) transfers of inventory and receivables are protected to the extent that they do not at the expense of other conditions reduce any collateral deficiency which may have existed at the beginning of the appropriate critical period.

The return of equivalent value found in these exceptions is consistent with an economic model that supports recapture of preferences to preserve the going concern value of the enterprise. The § 547(c) exchanges provide the debtor with the necessary means of continuing the business without diminishing the assets of the enterprise.

46. As already noted, these important legislative premises of the Bankruptcy Code are threatened by pending legislation and by case law insensitive to the new integration. See supra text accompanying notes 14-16.
B. A Case Study in Legislative Intent: Preserving the Integrity of the New “Antecedent Debt”

The concept of an antecedent debt was critical under section 60 and is equally critical under the Code. The phrase appears to be almost self-explanatory. The debt must occur before the transfer. If the language of section 60 had been applied literally, many ordinary and important transactions would have fallen within the definition of a preference. For example, a monthly bill from the ordinary trade creditor or utility company for goods or services would have been considered a preference. Similarly, payments to employees typically made at the end of a weekly, bi-weekly or monthly period would have been preferences. Because avoidability under the old Act was related to a creditor's state of mind, most of these transfers, however, were protected because the trustee usually had great difficulty proving that such creditors had reasonable cause to believe the debtor was insolvent. There were instances, however, when this requirement did not shield these creditors, especially employees, who did obtain knowledge of the debtor's troubled circumstances. When the creditor was aware of the bankrupt's fiscal problems, courts indulged the fiction that these pay-

47. Many of the early case law "refinements" of the antecedent debt requirement did not involve security transfers at all. The way in which these "refinements" have been dealt with under the new statute is, however, generally instructive on the nature of the new definition in section 547(b) and its relationship with the exceptions in section 547(c).

48. This element was difficult to prove and often made legitimate recapture expensive or even impractical. MARK-UP MINUTES, supra note 12, at 551. Circumstances causing suspicion or merely indicating that the creditor is apprehensive do not necessarily indicate a reasonable cause to believe that the debtor was insolvent. See, e.g., In re Solof, 2 F.2d 130, 132 (9th Cir. 1924) (trade creditors taking precautionary measures). See also Cusick v. Second Nat'l Bank, 115 F.2d 150 (D.C. Cir. 1940) (mere late payments held insufficient to prove creditor knowledge). A delay in payment, however, is one of the circumstances which, when combined with other factors, is sufficient to put the creditor on inquiry notice. See, e.g., Margolis v. Gem Factors Corp., 201 F.2d 803 (2d Cir. 1953).

Many employees would have significant knowledge of their employer's financial condition, thus jeopardizing wage payments during the critical prebankruptcy period. Trade creditors and utility companies were less likely to obtain early knowledge of sufficient facts to create the notice. Trade creditors who became aware of the debtor's apparent insolvency could have switched to cash transactions. They might have chosen, however, "to ride out the storm" with a loyal customer. The utility company would have had little choice if it obtained the requisite knowledge, since it could not as a practical matter deal on a cash basis. It would have been forced either to discontinue service or accept payment as usual at risk of trustee avoidance. Discontinuance of service would have been disastrous for the struggling debtor.

ments were for "current expenses," and not for an "antecedent debt."\textsuperscript{50} The result may have been defensible, but the reasoning was less than forthright.\textsuperscript{51}

The rationale behind the "current expense" cases was the need to protect ordinary course transactions between the creditor and the financially troubled debtor, irrespective of the creditor's perception of the debtor's problem.\textsuperscript{52} Apparently, the courts viewed the continued efforts of these types of creditors to be largely responsible for whatever wealth remained in the bankrupt's estate. Moreover, these arrangements, although technically credit transactions, did resemble cash transactions.\textsuperscript{53} The trouble, however, with this distortion of the antecedent debt concept was that it was not easily confined to cases truly resembling cash transactions.\textsuperscript{54}

The new preference section, with its list of precisely tailored exceptions, takes a more direct and controlled approach. In sections 547(c)(1) and 547(c)(2), Congress protected many "worthy" transactions formerly protected under the awkwardly constructed section 60 case law defining antecedent debt. The new structure signals a new integration of definition and exception. Congress clearly abandoned the case law distortions of the "antecedent debt" element and in its place enacted in section 547(b) a mechanical strict-timing concept of "antecedent debt," free from the cumbersome requirement that the creditor have "reasonable cause to believe." Section 547(c) provides the only exceptions to this concept.

The new antecedent debt element emerges clearly from the legislative history. In two early bills, the so-called Commission Bill and Judges' Bill, the definition of antecedent debt was drawn to exclude certain transfers of the types previously discussed.\textsuperscript{55} The Commission

\textsuperscript{50} See, e.g., Blauvelt v. Walker, 72 F.2d 915 (4th Cir. 1934) (wages); In re Barrett, 6 Am. Bankr. R. 199 (1901) (rent).

\textsuperscript{51} Cases to the contrary include: In re Great Lakes Lumber Co., 8 F.2d 96, 97 (D.C. Cir. 1925); In re John Morrow & Co., 134 F. 686, 687-88 (S.D. Ohio 1901).

\textsuperscript{52} See, e.g., Blauvelt v. Walker, 72 F.2d 915 (4th Cir. 1934).

\textsuperscript{53} The courts also considered the secured inventory or accounts creditor, who in no way resembles one dealing on a cash basis, equally worthy of this protection. The courts developed theories to protect these creditors, but not based on the concept of antecedent debt. See infra text accompanying notes 81-101.


\textsuperscript{55} For a discussion of these two bills, see supra note 11. For a side-by-side comparison of
Bill contained a short grace period and a list of transfers deemed not an antecedent debt, basically payments for utilities, personal services, and inventory. The Judges' Bill attempted to reach similar results by a far longer grace period and a shorter list of exceptions. The short grace period of the Commission Bill was apparently a response to the strict, mechanical application of the definition of antecedent debt in *National City Bank v. Hotchkiss*.

This early statutory approach was subject to two lines of attack. First, dissatisfied creditors who did not fit within the exceptions to the definition of antecedent debt objected to the preferred treatment of utilities, employees, and inventory creditors. These types of creditors, these two proposals, see Bankruptcy Act Revision: Hearings on H.R. 31 and H.R. 32 Before the Subcomm. on Civil and Constitutional Rights of the House Comm. on the Judiciary, Appendix 1, 94th Cong. 1st and 2d Sess. (1975), reprinted in 7 A. Resnick and E. Wypyski, Bankruptcy Reform Act of 1978: A Legislative History 1-332 (1979).

The definition of antecedent debt is found at § 4-607(g) of the Commission Bill and § 4-607(h) of the Judges' Bill. *Id.* at 180.

56. Commission Bill, § 4-607(g) provides:

Definitions.—For the purpose of this section, the following definitions are applicable:

(1) The term “antecedent debt” is a debt incurred more than five days before a transfer paying or securing the debt. The term “antecedent debt” does not include (A) a debt for personal services, (B) a debt for utilities incurred within three months of the petition, (C) a debt for inventory paid for within three months of the delivery of the goods in the ordinary course of the debtor’s business, or (D) an obligation to transfer ownership arising out of a contract for the sale of property owned by the debtor and in existence either at the date the contract was entered into or at a time more than three months prior to the petition.

57. Judges' Bill, § 4-607(h) provides:

(h) Definitions.—For the purpose of this section, the following definitions are applicable:

(I) the term “antecedent debt” is a debt incurred more than thirty days before a transfer paying or securing the debt. The term “antecedent debt” does not include a debt for personal services entitled to priority under section 4-405(a)(3) of this title.


59. This pattern of complaint is worthy of notice, for it reemerges in the present support for a legislative assault on the preference scheme. These creditor organizations objected to exceptions that aided others. At the same time, they objected to the fundamental statutory changes that put payments to them in jeopardy. Many of these creditor organizations objected, therefore, to the presumption of creditor insolvency during the 90 days before bankruptcy or the elimination of the element of “reasonable cause to believe.” They supported, however, those changes that would protect payments to them. The 30-day grace period in the antecedent debt definition, therefore, received a great deal of support from these creditors. 1975 Senate Hearings, supra note 43, at 438 (statement of Richard Kaufman on behalf of National Association of Credit Management); id. at 457, 464-65, 469 (statement and testimony of Robert Grimmig on behalf of the American Bankers Association); 1976 House Hearings, supra note 43, at 2503 (testimony of John Ingraham on behalf of Robert Morris Associates and the National Association of Bank Loan and Credit Officers).
perhaps with an overly optimistic view of the meaning of the section, nevertheless supported the thirty-day grace period in the Judges' Bill.

In contrast, a second group of challengers sought to narrow or eliminate the exceptions, particularly those written into the definition of antecedent debt. The National Bankruptcy Conference opted for a narrower set of exceptions to the antecedent debt definition. Professor Countryman objected to attempts to protect certain types of "ordinary course" creditors. Both the Conference and Countryman objected to the redefinition of antecedent debt with its inflexible five- or, thirty-day grace period. The Conference preferred a retention of the section 60 case law represented by Dean v. Davis and National City Bank v. Hotchkiss. Although the true significance of these cases was lost in some of the subsequent discussions comprising the legislative history, it did not escape Professor Countryman or the Conference.

The critical distinction between these two decisions is found by comparing the intentions of the parties involved in the transfer. In Dean v. Davis, a contemporaneous transfer was intended, but the transfer was delayed a few days beyond the credit extension. In Hotchkiss, the parties initially intended an unsecured obligation, but hours after the credit was extended security was granted. In Dean v. Davis, the Court declared the transfer unavoidable as being not for an antecedent debt, while in Hotchkiss the transfer was avoidable despite the shorter period. The mechanically defined grace periods of both the Commission and Judges’ Bill ignored the question whether the parties actually intended a contemporaneous exchange. The National Bankruptcy Conference preferred a more flexible approach but wished to retain the actual intention requirement.


61. 242 U.S. 438 (1917).

62. 231 U.S. 50 (1913).

63. The Commission Report does not indicate whether the grace period in the Commission Bill was designed to create a conclusive presumption that the parties intended a contemporaneous exchange. The note on Hotchkiss contained in the report emphasizes the small time gap between credit extension and the grant of security. It does not refer to the absence of an original intent to create a secured obligation. COMMISSION REPORT (pt. 2), supra note 8, at 169.

64. NBC Bankruptcy Act of 1975, supra note 60, at 363, 365 n.1. The Conference would have
Congress subsequently adopted the results of much of the section 60 case law on antecedent debt, including the rules of *Dean v. Davis* and *Hotchkiss*. Congress, however, made a significant change from the approach found in the case law and in the Commission and Judges' bills. Rather than artificially defining antecedent debt, Congress, in section 547(c)(1), protected preferential transfers which were substantially contemporaneous if they were intended to be contemporaneous. By protecting these transfers in section 547(c)(1), Congress implicitly recognized that delay of a transfer, however minimal, would make that transfer for or on account of an antecedent debt.

Congress also decided to continue the protection of trade creditors, employees, and utilities but again rejected the approach developed in section 60 case law and followed in the Commission and Judges' bills. The exceptions to the definition of antecedent were eliminated, and these transfers to these creditors were treated as preferences within the definition of section 547(b). In section 547(c)(2), however, transfers to these parties were explicitly protected from avoidance as long as the carefully drawn limitations were met.65

In choosing this approach, Congress opted for a clean, mechanical, and highly inclusive definition of a transfer for antecedent debt.66 Even payments by check, traditionally likened to cash payments under section 60, arguably fall within the new definition of a preference and are saved only by resort to section 547(c)(1).67 From the legislative his-
tory, it is clear that Congress abandoned the artificial contortion of the
definition of a preference and substituted a forthright statement of
those transfers entitled to protection.

C. Deriving a Rule of Construction

The history of the "antecedent debt" element is a guide to the proper
role for all the parts of the preference definition in section 547(b). In
opting for a list of explicit exceptions, Congress created a new purpose
for the definition subsection. The definition subsection, however, has
many old parts. The transplantation of old section 60 language along-
side new language and concepts into section 547 requires the proper
choice between conflicting rules of statutory construction. On the one
hand, it is a well settled maxim of interpretation that when a statute or
part of a statute has been construed by the courts and is subsequently
reenacted without material change, the legislature is presumed to have
adopted the existing judicial construction. On the other hand, if the
reenactment occurs along with sufficient substantive revision, the legis-
lature probably intended a "fresh start" despite the transplanted lan-
guage. In interpreting section 547, it is essential to construe the old
language consistently with its new context in order to further the pur-
purpose of the legislative changes.

Old section 60 definitional language must be construed in the context
of section 547(c) and the new integration of preference law. To en-
hance the equality of the distribution, creditor knowledge has been

state law. U.C.C. § 2-511, § 2-507 & § 3-802. It is not, however, an immediate assignment of
funds. Id. § 3-409. Under the clean new approach to antecedent debt taken by Congress in
§ 547(b), a check is technically a credit transaction for bankruptcy purposes. MARK-UP MINUTES,
supra note 12, at 562 (statement by Mr. Klee in response to an observation by Representative
Drinan). At least one commentator has viewed the House and Senate reports on this point as
containing a misleading aberration. See P. MURPHY, CREDITORS' RIGHTS IN BANKRUPTCY
§ 10.14 (1980). The reports are consistent, however, with the new definitional context for "antece-
dent debt" and with the elements of § 547(b) generally. See infra text accompanying notes 248-66.

68. Although canons of statutory construction are the accepted conventional vocabulary of
interpretation, they need not enslave us. As Professor Llewellyn pointed out: "There are two
opposing canons on almost every point. On every point there is a 'thrust' and 'parry.' " Llewel-
lyn, supra note 41, at 403.

69. See Mrugala v. City of Boston, 330 Mass. 707, 708, 115 N.E.2d 148, 149 (1953). See also
R. DICKERSON, THE INTERPRETATION AND APPLICATION OF STATUTES 130-31, 182-83 (1975);
Llewellyn, supra note 69, at 403.

70. R. DICKERSON, supra note 69, at 130-31, 182-83; 2 J. SUTHERLAND, STATUTES AND STAT-
UTORY CONSTRUCTION §§ 49.09, 40.10 (Sands 4th ed. 1972); Llewellyn, supra note 41, at 403.
made irrelevant and the trustees’ burden of proof has been eased. Rather than engrafting exceptions for “worthy” transfers onto the definitional language, Congress has forthrightly opted for a clean definition and a list of specific exceptions. Section 60 case law perpetuating alternative exceptions has no place in this structure.

Abandonment of these cases will have substantial impact on transfers incident to commercial financing. The protective case law concepts of section 60 were often overly generous to the creditor. Since these concepts are no longer applied, creditors will be limited to the carefully drawn section 547(c) exceptions.

Thus, as it affects commercial financing arrangements, the primary theory of integration in the new preference structure has three related premises:

1. The preference definition in subsection (b) calls for a strict, mechanical timing test for transfers within the critical period;
2. The exclusive list of transfers in subsection (c) should not be expanded by reading old case law qualifications into the transplanted definitional language of subsection (b);
3. Subsection (c) should be strictly construed according to its language and intended scope.

This new integration should reduce administrative expenses incident to recapture and result in larger, fairer distributions from the estate.

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71. See supra text accompanying notes 29-30.
72. The generous nature of this protective case law is discussed throughout Part IV. See, e.g., infra text accompanying notes 81-112 & 160-207.
73. The new clean language defining creditor improvement in § 547(b)(5), and the new context for the transplanted antecedent debt requirement will have a particularly important impact on after-acquired property financing. See infra text accompanying notes 125-236.
74. Some flexibility does exist in these exceptions, but only where the language requires factual determinations of a flexible nature. For example, § 547(c)(1) requires the transfer to be at least substantially contemporaneous. Congress followed the National Bankruptcy Conference’s suggestion and opted for judicial flexibility over an arbitrary five- or thirty-day period. Similarly, with respect to § 547(c)(2), the court must determine whether the debt was incurred in ordinary course, whether payment was made in the ordinary course, and whether the transfer was made according to ordinary business terms. See infra text accompanying notes 267-69. This permits flexible adjustments to the circumstances of particular transactions and particular industries.
75. The Senate Report of May 27, 1982, on the Bankruptcy Improvement Act of 1981, S. 2000, concludes that restoring the requirement that the trustee prove “reasonable cause to believe” protects “good faith creditors.” The report further concludes that the “evidence” fails to show that the Reform Act provisions have “resulted in significant increases of distributions from the estate.” See S. Rep. No. 446, 97th Cong., 2d Sess. 23-24 (1982). The hearing evidence, however, does not support the negative inference concerning a statutory integration which has not really had a chance to sort itself out from the older case law. See supra note 15.
IV. THE NEW SECTION 547(b).

A. Basic Principles

Section 547(b) is the first operative stage of the new preference law. Exceptions provided in section 547(c) are only relevant if the trustee proves that all the elements of a section 547(b) preference are present.\(^7^6\) The challenge for courts dealing with section 547(b) is to interpret this section consistent with the function of section 547(c) while retaining the important wisdom in the transplanted section 60 language.\(^7^7\)

The statute provides some explicit guidance. Where section 60 concepts remain vital to the section 547(b) definition, there are usually strong indications in the legislative history that these concepts carry over to section 547(b).\(^7^8\) For example, some of the case law concepts

\(^7^6.\) There was no mention of burden of proof in the floor debates or committee reports. The substantive structure of the section certainly suggests that the trustee must prove the elements of § 547(b) and the creditor the elements of § 547(c). Further indication of congressional intent may be derived from the drafting history of the preference section and from the Senate Report on the Technical Amendment.

Both the Commission Bill and Judges' Bill defined a preference merely as a transfer by an insolvent debtor for antecedent debt during the critical period. That section specifically gave the trustee the burden of proving these elements under § 4-607(a). Subsections (b), (c), and (d) of § 4-607 contained the exceptions to the preference definition. Among these exceptions was "the non-preferential effect," a transfer which "did not enable the creditor . . . to obtain a greater percentage of his claim . . . ." § 4-607(b)(3). Subsection (d) contained the exception for receivables and inventory. The only mention of any burden of proof in the exceptions was contained in subsection (d). This subsection expressly placed the burden on the trustee of proving "an improvement in position by an increase in value of security at the expense of the estate and the extent thereof." § 4-607(d). Apparently, the creditor carried the burden of proving all other elements of the exceptions, including the fact that a transfer to him did not enable him to obtain a greater percentage of his claim than other creditors.

After considering this earlier draft, the allocation of burden of proof of § 547 can be accurately inferred. All the elements of a preference, including the "receives more" test, were relocated in the subsection defining a preference. The trustee clearly has the burden of proving these elements, even though the express reference to burden of proof was deleted. The creditor was relieved of proving that a transfer did not enable him to receive more. Moreover, the reference to the trustee's burden in the inventory and receivables exception was deleted, putting the burden of proof for this exception on the creditor consistent with the other exceptions. For a proper allocation of the burden, see In re Brown, 20 Bankr. 554, 555 (Bankr. S.D.N.Y. 1982). This burden of proof sequence suggested by the Code appears as an express allocation in the 1981 Technical Amendments. See Bankruptcy Amendments Act of 1981, S. 863, supra note 23, at § 48(f). Under the proposed § 547(g), the trustee has the burden of proving the elements of a preference under § 547(b). The challenged creditor has the burden of proving nonavoidability under § 547(c). Although the burdens are explicitly stated under new § 547(g), the additions merely clarify present law. See S. Rep. No. 150, supra note 23, at 11.

\(^7^7.\) See supra text accompanying notes 71-75.

\(^7^8.\) For example, retention of the rule of Palmer Clay Prods. Co. v. Brown, 297 U.S. 227
broadly defining the phrase "transfer to or for the benefit of a creditor," which have been taken verbatim from section 60, clearly have continuing validity in section 547(b). 79 In contrast, case law which deemed a transfer of property to occur before the debtor acquired that property has been expressly overruled by language in section 547(e). 80 Between these two extremes are case law concepts neither clearly embraced nor clearly rejected by the language and the legislative history of section 547(b). This case law must be carefully reexamined to determine if it is compatible with the new integration of preference law.

This section of this Article discusses section 60 case law concepts that are included and those that are expressly excluded under section 547. More importantly, concepts between the extremes which have been displaced by the new context of the transplanted definitional language are identified. Finally, the operation of section 547(b) on transfers to a secured party with an interest in after-acquired property is examined with several illustrations.

(1936), is strongly suggested by the legislative history. See infra note 128. See also infra text accompanying notes 137-39.

79. SENATE REPORT, supra note 12, at 27; HOUSE REPORT, supra note 12, at 314. The two reports indicate that the changes in definition of transfer in § 101(40) were designed to eliminate those phrases which might be construed as limiting the broad definition. Set-offs were expressly incorporated in an earlier version of the definition, H.R. 8200, 85th Cong., 1st Sess. (1977), but deleted after protection for set-offs was removed from § 547. S. 2266, 95th Cong., 2d Sess. § 101(40) (1978); 124 CONG. REC. H41,090 (daily ed. Sept. 28, 1978) (remarks of Rep. Edwards); 124 CONG. REC. S17,407 (daily ed. Oct. 6, 1978) (remarks of Sen. DeConcini). Set-offs are not avoidable as preferences because they are no longer transfers. Set-offs are disallowed or limited, however, in § 553. Section 553(b) provides a limitation on set-offs similar to that contained in § 547(c)(5). A set-off is permitted only to the extent that the gap between the claim against the debtor and the debtor's "mutual" claim has not been narrowed within the 90-day period. Therefore, no practical consequences follow from exclusion of the term from the definition of transfer.

This is the only instance where Congress artificially narrowed its broad definition of transfer. It did so expressly and apparently for the purpose of maintaining the exclusive role of § 547(c) in carving out exceptions to § 547(b) preferences. Since all issues involving set-offs were to be treated under § 553, Congress chose to eliminate set-offs from § 547(b). They did so by excluding set-offs from the definition of transfer. Once again, § 547(c) contained the only exceptions to preferences meeting all the elements of subsection (b).

For a recent case which reads "transfer" of property of the debtor very broadly in denying a motion to dismiss, see In re Moskowitz, 13 Bankr. 357 (Bankr. S.D.N.Y. 1981). But see HOUSE REPORT, supra note 12, at 367-68.

Although the increase in value of property previously transferred to the creditor does benefit the creditor, such benefit may not be caused by or be traceable to a transfer which occurs during the critical period. Appreciation of the value of collateral already subject to a security interest is not a transfer.

80. See infra text accompanying notes 106-09.
B. The Role of Section 60 Case Law

1. "A transfer is not made until the debtor has acquired rights . . . ."

Under the Act a transfer included the receipt of additional or new security under a prior agreement granting an interest in after-acquired property. When the collateral was a constantly shifting mass, much, and perhaps all, of the collateral existing on the date of bankruptcy might have been acquired during the critical four-month period. Under Article 9 of the UCC, a security interest does not attach until the debtor obtains rights in the collateral and cannot be perfected until attachment. Therefore, interests in after-acquired property, including

81. Section 1(30) provided in part: Transfer shall include the sale and every other and different mode, direct or indirect, of disposing of or of parting with property or with an interest therein . . . or of fixing a lien upon property or an interest therein . . . as a conveyance, sale, assignment, payment, pledge, mortgage, lien, encumbrance, gift, security, or otherwise; the retention of a security title to property delivered to a debtor shall be deemed a transfer suffered by such debtor.


82. U.C.C. § 9-203 (1978) provides:

(1) Subject to the provisions of Section 4-208 on the security interest of a collecting bank, Section 8-321 on security interests in securities and Section 9-113 on a security interest arising under the Article on Sales, a security interest is not enforceable against the debtor or third parties with respect to the collateral and does not attach unless:

(a) the collateral is in the possession of the secured party pursuant to agreement, or
the debtor has signed a security agreement which contains a description of the collateral and an addition, when the security interest covers crops growing or to be grown or timber to be cut, a description of the land concerned;

(b) value has been given; and

(c) the debtor has rights in the collateral

(2) A security interest attaches when it becomes enforceable against the debtor with respect to the collateral. Attachment occurs as soon as all of the events specified in subsection (1) have taken place unless explicit agreement postpones the time of attaching.

83. U.C.C. § 9-303 (1978) provides:

(1) A security interest is perfected when it has attached and when all of the applicable steps required for perfection have been taken. Such steps are specified in Sections 9-302, 9-304, 9-305 and 9-306. If such steps are taken before the security interest attaches, it is perfected at the time when it attaches.

The key cases involving potentially preferential transfers of security interests in after-acquired property were decided under the 1962 version of Article 9. Although the Official Text underwent substantial revision in 1972, the drafters did not alter the time at which a security interest attached to specific collateral. Under the 1962 version, a security interest could become enforceable as soon as a signed security agreement was executed. It could not attach under § 9-204(1), however, until there was an agreement, value had been given and the debtor had rights in the collateral. The 1972 revisions made the time of attachment and the time a security interest was enforceable identical, and consolidated these timing provisions in § 9-204. No change was made in § 9-303.
the floating lien, were potentially preferential under section 60.\textsuperscript{84} The UCC sought to avoid this result through the operation of section 9-108.\textsuperscript{85} Under this provision, certain security interests are “deemed to be taken for new value and not as security for antecedent debt.”\textsuperscript{86} Section 9-108 was generally considered “a clumsy attempt to perpetrate a fraud on the Bankruptcy Act.”\textsuperscript{87} The validity of security interests in collateral acquired during the critical pre-petition period remained in doubt, and the potential “insecurity” of the floating lienholder was abhorrent to most commentators.\textsuperscript{88}

Judicial treatment of the floating lien in bankruptcy was more favorable than the secured creditors imagined possible.\textsuperscript{89} Central to the courts’ analyses were the numerous theories that either placed

\begin{itemize}
\item If the transfer occurred, at the earliest, when the security interest attached, security interests in property which the debtor acquired subsequent to the debt would necessarily have been transfers for antecedent debt.
\item U.C.C. § 9-108 (1978) provides:
\begin{quote}
When After-Acquired Collateral Not Security for Antecedent Debt
Where a secured party makes an advance, incurs an obligation, releases a perfected security interest, or otherwise gives new value which is to be secured in whole or in part by after-acquired property his security interest in the after-acquired collateral shall be deemed to be taken for new value and not as security for an antecedent debt if the debtor acquires his rights in such collateral either in the ordinary course of his business or under a contract of purchase made pursuant to the security agreement within a reasonable time after new value is given.
\end{quote}
This is identical to the 1962 version.
\item Id.
\item Even the clumsy attempt in § 9-108 to perpetuate “fraud” was cited approvingly in some cases. See Mills Morris Co. v. Scanlon, 446 F.2d 722 (5th Cir. 1971); Biggins v. Southwest Bank, 322 F. Supp. 62 (S.D. Cal. 1971), modified, 490 F.2d 1304 (9th Cir. 1973); Rosenberg v. Rudnick, 262 F. Supp. 635 (D. Mass. 1967).
\end{itemize}
transfers of security interest outside the four-month period or found the transfer not to be for an antecedent debt. The most notable cases, DuBay v. Williams and Grain Merchants of Indiana, Inc. v. Union Bank seemed to insulate all collateral acquired under any Article 9 security interest if the interest had been perfected in a timely manner.

The issue in DuBay and Grain Merchants was whether a transfer of a security interest in an account could occur before the account was created. For example, in DuBay the Rose City interests in accounts which came into existence during the four-month period were “deemed” to be transfers at the time of filing—before the four-month period. The court found support in section 60(a)(2) which deemed a transfer of personal property to occur when “it became so far perfected” that the interest would not be inferior to a judicial process lien creditor. Although this is a possible reading of section 60(a)(2), the section was probably designed to postpone the date of transfer when tardy perfection occurred, not to advance it in the case of timely perfection. Congress

90. 417 F.2d 1277 (9th Cir. 1969).
91. 408 F.2d 209 (7th Cir. 1969).
92. The Bankruptcy Act, § 60(a)(2) provides:

For the purposes of subdivisions a and b of this section, a transfer of property other than real property shall be deemed to have been made or suffered at the time when it became so far perfected that no subsequent lien upon such property obtainable by legal or equitable proceedings on a simple contract could become superior to the rights of the transferee.

Under U.C.C. § 9-301(1)(b), a creditor must become a lien creditor before a security interest is perfected in order to have priority over the secured party. If the necessary steps for perfection occur before the debtor obtains rights in specific collateral, the security interest in that collateral will be perfected at the moment the debtor obtains those rights. Since U.C.C. § 9-301(3) defines a lien creditor to be a creditor who has acquired a lien on the property involved, a lien creditor generally becomes a lien creditor vis-a-vis specific property, at the earliest, when the debtor has rights in the collateral. See generally Ward, Ordering the Judicial Process Lien and the Security Interest Under Article Nine: Meshing Two Different Worlds Part I—Secured Parties and Post-Judgment Process Creditors, 31 Me. L. Rev. 223 (1980). As a result, the best the lien creditor can normally do is “tie” the secured party, that is, become a lien creditor simultaneously with the secured party’s perfection. A tie is insufficient to subordinate the security interest to the lien creditor. Thus, under the reasoning of DuBay and Grain Merchants, once a security agreement has been executed, value given, and a financing statement filed, the security interest in yet to be acquired property is “so far perfected,” although not yet perfected, that it can never be inferior to the judicial process lien creditors. 408 F.2d at 212-13. Support for this approach also appeared in the law review literature. See, e.g., Hogan, Games Lawyers Play with the Bankruptcy Preference Challenge to Accounts and Inventory Financing, 53 Cornell L. Rev. 553 (1968); Kripke, The Code and the Bankruptcy Act: Three Views on Preferences and After-Acquired Property (pt. 2), 42 N.Y.U.L. Rev. 284 (1967).

93. Note that the definition of transfer included “fixing a lien upon property.” See 11 U.S.C. § 1(30) (1976). Similarly, a preference included a transfer of any property of the debtor. Id.
designed the old preference section without consideration of the problem. The language of section 60 existed long before the modern floating lien was developed. DuBay is best seen as an opinion protecting the security interest in after-acquired property against trustee avoid-

\[ \text{§ 60(a)(1). Both definitions focus upon specific property. Clearly a debtor cannot actually transfer property, or an interest in property, unless he has rights in that property. Even \text{§ 60(a)(2)} seems to presuppose that the property already belonged to some extent to the debtor. A transfer of property is deemed to have occurred when "it became so far perfected. . . ." Transfer, where security interests were involved, under \text{§ 1(30)}, included the parting with an interest in property or fixing a lien upon property. If the word "it" has any meaning, then it likely refers to an already existing transfer not yet perfected. See Countryman, supra note 87, at 277.} \]

In 1938, \text{§ 60} was revised to overrule Sexton v. Kessler, 225 U.S. 90 (1912). In Kessler, Justice Brandeis insulated from trustee attack a transfer for securities on the eve of bankruptcy. Four years earlier, the security interests had been granted in the securities, but no delivery made. Although the securities were not properly pledged by delivery until 1907, an equitable lien valid in bankruptcy arose in 1903. The 1938 revision added the "so far perfected" language, but required the interest to be good against all bona fide purchasers. As Gilmore has noted, this language not only did away with this type of equitable lien, but also put at risk much accounts receivable financing and all inventory financing. The 1950 revision retained the "so far perfected" language, but substituted the lien creditor test in cases involving personal property. See 2 G. Gilmore, supra note 6, at §§ 45.3-45.4; Hogan, supra note 92, at 567-68. There are virtually no preference cases dealing with pre-Code floating security interests under \text{§ 60} after 1938.

Interestingly enough, the drafting of Article 9 and the 1950 version of \text{§ 60} took place at the same time, but without "effective liaison." When new \text{§ 60} emerged in 1950, it was apparently too late to undertake the massive conceptual changes necessary to make the Article 9 security interest safer under \text{§ 60}. 2 G. Gilmore, supra note 6, § 45.3, at 1303 n.15. See also Gilmore Committee Report, supra note 9, at 207. The "Article 9" security interest in a sense meshed too well with the language of \text{§ 60}—the attachment, or "fixing," of a security interest, or "lien," on property, which occurred when the debtor acquired rights in the property, seemed to make a transfer possible, at the earliest, on the date of attachment. The concepts designed primarily to simplify priority contests between secured creditors seemed to invite a preference challenge to after-acquired property financing.

\[ \text{94. See supra text accompanying note 8. Some have unconvincingly sought support in the legislative history of the 1938 and 1950 changes. For example, the DuBay opinion bolsters its interpretation by pointing out that Congress in 1950 amended \text{§ 60(a)(2)} "to loosen the flow of credit to small businessmen whose financing had been seriously impaired by the old bona fide purchaser test." 417 F.2d at 1289. See also 408 F.2d at 214. The 1950 changes were designed to undo the unintentional damage to inventory and accounts receivable financing in 1938. See supra note 93. The prevalent forms of after-acquired property financing (warehousing, trust receipts, factoring and receivables financing), operating under the strictures of Benedict v. Ratner, 268 U.S. 353 (1925), were carried out "on a new value or revolving credit basis." 2 G. Gilmore, supra note 6, § 45.6, at 1309; Henson, supra note 87, at 374. Nonetheless, a bona fide purchaser of the account still enjoyed priority over the secured party. Therefore, the transfer would have been postponed until the filing of the petition under \text{§ 60(a)(2)}, and would have been at least theoretically avoidable.} \]

While the 1950 amendment restored new value or revolving credit based financing, it could not "restore" a form of floating lien yet to be born, a form perfected by notice filing. The efficiency associated with the Article 9 security interest in after-acquired property is based upon this filing replacing the new credit type of arrangement necessitated by Benedict, 268 U.S. 353. In fact, \text{§ 9-}
ance in order to preserve the integrity of a significant form of modern financing—the floating lien. 95

Other theories, such as the res (or “Mississippi River”) theory 96 and the misnamed substitution theory, 97 were devised to provide similar

108 can be viewed as an attempt to engrat the fiction of new value on the notice filing system. See supra text accompanying notes 82-89.

95. The DuBay court quite correctly saw that to destroy the floating lien in bankruptcy, “would impair, not promote, the intent of the draftsmen of the Uniform Commercial Code to make security transactions conform to the legitimate needs of commerce, rather than to the common-law lawyer’s wish for conceptual nicety.” 417 F.2d at 1289. To avoid this distasteful result, the court decided the case as it did. But see Skilton, supra note 5, at 1014-16.

96. The theory has been called res, entity, and Mississippi River Theory. See, e.g., 2 G. Gilmore, supra note 6, § 45.5, at 1307-08 (entity); Friedman, supra note 88, at 215-16 (res); Henson, “Proceeds” Under the Uniform Commercial Code, 65 COLUM. L. REV. 232, 233-34 (1965) (Mississippi River). Professor Henson gained instant immortality when he jumped from the paradox of Heraclitus to the life of Huck Finn to suggest that although you cannot step twice into the same river, since a river constantly changes, you can step twice into the Mississippi. Regardless of name, the theories merely stated that receivables and inventory should be viewed as an entity or aggregate which usually exists at the time when the debt is created or, when a financing statement is filed, most often before the four-month period. Subsequent changes in the composition of the mass were not viewed as relevant. Since the transfer of the original entity or aggregate was not for antecedent debt or occurred prior to the four-month period, there was no preference.

97. Countryman refers to this as relaxed substitution, since actual substitution theory required that the substitution be substantially contemporaneous with the release and the new collateral not exceed the old in value. Any excess value was preferential. Countryman, supra note 87, at 277-78; see also 3 COLLIER ON BANKRUPTCY § 60.21 (14th ed. 1976). Actual substitution involves a transaction in which original collateral is released in exchange for new collateral. Relaxed substitution entertains the fiction that all changes of collateral are viewed as a single transaction, with no preference as long as the end result is no diminution of the estate. 408 F.2d at 217-18; 2 G. Gilmore, supra note 6, § 45.6. The theories are separately criticized in Countryman, supra note 87, at 275-80. In addition a so-called “sophisticated-res” theory was referred to in a footnote in DuBay. 417 F.2d at 1287 n.8. This theory treated subsequent accounts or inventory as proceeds of earlier accounts or inventory. If there is “continuous perfection” under § 9-306, these transfers related back to the transfer of security interests in the original accounts or inventory. The concept of “continuous perfection” expressed in § 9-306 determines contests between competing creditors. The 1972 version of § 9-312 makes the purpose of this concept clear. For purposes of the first to file or perfect rule of § 9-312(5)(a), the priority dates back to “the time when a filing is first made . . . or the time the security interest is first perfected, whichever is earlier, provided that there is no period thereafter when there is neither filing nor perfection.” Comment 2(b) to § 9-306 attempts to make § 9-306(2), (3) a rule in bankruptcy for dating the transfer of the interest in the proceeds as the “date of the secured party’s obtaining the security interest in the original collateral.” While this is a valid rule for determining priorities between creditors under state law, it cannot determine when a transfer takes place for § 60 purposes. See generally Countryman, The Use of State Law in Bankruptcy Cases (pt. 2), 47 N.Y.U. L. REV. 631, 631-39 (1972).

At any rate, the theory could only be validly applied if sufficient control were exercised so that the identifiable proceeds of the accounts or inventory were utilized to obtain new accounts or inventory. With accounts, this would be nearly impossible, since new accounts are generated by the general work of the enterprise; unless the only source of funds is payments on encumbered
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protection. Despite these imaginative theories, both the Bankruptcy Act and the UCC seem to assume that a security interest attaches to a specific piece of property at a specific time and not to an undefined mass. The best metaphoric rejoinder to these theories appears in Referee Snedecor's opinion at the first stage of the DuBay litigation. Responding to Professor Henson's "Mississippi River" theory, he explained that there was no security interest in the river—the security interest was in each of the individual fish as it was caught.

The result of applying these theories was to validate all security interests in after-acquired property that were timely perfected. Most theories could have been applied even if the security interest were not in collateral which was a shifting mass, and even if there were an anomalous build-up in collateral during the four-month period.

Once notice of the debtor's insolvency became irrelevant to the new preference scheme, the predominant purpose of preference law more clearly became creditor equality. Therefore, the state of affairs

accounts, tracing of proceeds will become increasingly difficult in each subsequent generation of accounts.

Some support was also sought in the "negative implication" of § 60(a)(6). Under that section, part of the 1950 revision, only an equitable lien was created if the steps for perfection consistent with state law and § 60(a)(7) had not been timely made. This section expressly made equitable liens avoidable. It continued to repudiate the relation back doctrine that led to the 1938 amendment. According to the "negative implication" theory, if there was no tardy perfection, no preference should be found. Coogan & Bok, supra note 88, at 244-45. Although this subsection enforces a policy in favor of timely perfection, it cannot be read as designed to validate forms of financing not extant at the time of adoption.

Similarly, no comfort could be derived from § 60(c) or § 60(a)(8) unless new credit had been extended or a future loan had been made. Coogan & Bok, supra note 88, at 245. However, the release of collateral may be new value for § 547(c)(4) purposes. See infra text accompanying notes 295-96.

100. See supra text accompanying notes 81-84.

101. Theories which somehow moved the transfer back to the creation of the debt or outside the four-month period protect the creditor even if there is an unlikely build-up of collateral. If the build-up was forced by the creditor or initiated by the debtor to prefer the creditor, the transfers could be attacked under § 67(d) or § 70(c). See GILMORE COMMITTEE REPORT, supra note 9, at 20. Although language in some opinions seemed to limit the protection to the extent there was no improvement of position during the critical period, only the substitution theory made this limitation explicit. The relaxed substitution theory permitted transfers to the extent the aggregate of transfers did not increase the value of collateral. see, e.g., Grant Merchants, 408 F.2d at 217-18.

102. See supra text accompanying notes 42-44.
which existed under these theories was no longer tolerable. A proper result required a balancing of the equities of the unsecured creditors with those of the Article 9 creditor with a floating lien. The essence of the floating lien is the change in the composition of the debtor’s property; collateral will be sold or cease to exist and new collateral will be acquired. Any approach that only recognized the acquisition of collateral, and therefore treated all acquisitions during the months before petition as voidable preferences, would seriously undermine the floating lien.\(^\text{103}\) On the other hand, the secured party should not be able to improve his position if the debtor’s money is channeled into collateral.\(^\text{104}\) At each stage of drafting, the new preference section struck a balance between the interests of the floating lien creditor and the interests of the general creditors.\(^\text{105}\) The floating lien was protected, but only to the extent that the creditor’s position did not improve.

Section 547 utilizes a direct approach to achieve this balance. First, Congress opted for “the fish rather than the river” theory in defining transfers of security interests in after-acquired property. Under section 547(e)(3) a transfer of a security interest in personal property cannot occur before the security interest has attached, that is, until the debtor has rights in the specific collateral.\(^\text{106}\) If the debtor already has rights in

\(^{103}\) See supra text accompanying notes 81-88.

\(^{104}\) If equality in distribution replaces the intent of debtor and creditor as the cornerstone of the preference section, the creditor is not entitled to a windfall. This is true not only when the creditor insisted on the channeling, but also when the debtor chose to channel, or when channeling occurred by chance.

\(^{105}\) The Gilmore Committee Report contained the initial formulation of the improvement of position test, § 60(a)(4)(IV), for inventory and receivables. Gilmore Committee Report, supra note 9, at 210-12. The Committee was split on whether a “reasonable cause to believe in debtor’s insolvency” should be an element of a preference. Id. at 209-10. However, this element was eliminated in § 60(a)(4)(IV) for inventory and receivables, a change that would have placed the creditor financing inventory and receivables in a theoretically less advantageous position than other creditors. The reason for this was purely administrative; the litigation aimed at determining when the creditor had reasonable cause to believe and the process of identifying which transfers came before and which after that point was labeled as complicated, expensive, tedious and asset-exhausting. Id. at 213. The change suggested by S. 2000 would create the same administrative problems in § 547(c)(5) which the Gilmore Committee sought to avoid. See supra note 15.

Under the Commission Bill, the policy of equality of distribution was already dominant. Commission Report, supra note 8, at 170 n.10. This was accomplished by elimination of the “reasonable cause to believe” element. The improvement of position test of § 4-607(d) was viewed as a compromise between the DuBay position, unfair to other creditors, and a true equality principle. Id. at 210.

\(^{106}\) Section 547(e)(3) provides: “For the purposes of this section, a transfer is not made until the debtor has acquired rights in the property transferred.” 11 U.S.C. § 547(e)(3) (Supp. V 1981).
the specific collateral at the time the debt and security interest are created, and if the security interest is perfected in a timely fashion—ten days—the transfer dates from the time of attachment of the security interest. Unless the security was granted after the debt was created, there will be no transfer for antecedent debt and no preference. For collateral, which is acquired after the effective date of the debt, however, the transfer cannot occur until the debtor acquires rights in the collateral. Congress has swept aside the theories supporting DuBay and Grain Merchants.

As will be demonstrated in the next section of this Article, security interests in collateral acquired after the effective date of the debt and within the critical pre-petition period will almost certainly be preferences. If they are not preferences it is because the security interests are superfluous, that is, unnecessary to secure the ultimate satisfaction of the debt. If the creditor needs the collateral to “secure” the debt, he will “receive more” with the transfer of the security interest than he would have received without it. The requirements of section 547(b)(5) will then be satisfied. Once a transfer is labeled a section 547(b) preference, the creditor will have to rely on section 547(c) to protect the trans-

107. Section 547(e)(2) provides: “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,” Id. § 547(e)(2)(A).

Section 547(e)(2)(A) uses the phrase "at the time such transfer takes effect between the transferor and transferee." Under U.C.C. § 9-203(1), a security interest is effective between the parties after there is a grant of security interest by possession or a signed written agreement, value is given, and the debtor has rights in the collateral. A security interest in property already owned by the debtor, therefore, takes effect after the granting of a security interest or the giving of value, whichever comes last.


The express language of § 547(e)(3) does not deal precisely with the definition of the “property” in which the debtor must acquire “rights” before a transfer is “made.” Arguably, therefore, the “entity theory” can still be read into § 547(e)(1) because the undifferentiated mass is the “property” referred to in § 547(e)(3). See V. Countryman, A Kaufmann & Z. Wiseman, Commercial Law 288-89 (1982) [hereinafter cited as V. Countryman]. This argument would certainly try the patience of the draftsman who clearly intended § 547(e)(3) to reach and dispose of the entity theory. “Property” must be given its ordinary meaning here. The focus is on discrete items, not on a generic description of the form of wealth. See Mark-up Minutes, supra note 12, at 555-A. It is clear from this discussion that in drafting § 547(e)(5) the subcommittee intended to dispose of all theories underlying DuBay and Grain Merchants.

110. See infra text accompanying notes 141-42.
fer. If the collateral is accounts or inventory, section 547(c)(5) provides a measure of protection.\textsuperscript{111} To a limited extent sections 547(c)(1), 547(c)(3), and perhaps 547(c)(4) also provide some protection for transfers of security interests preferential under section 547(b).\textsuperscript{112}

2. "Transfer . . . to or for the benefit of the creditor"

A section 547(b) preference must be a "transfer . . . to or for the benefit of the preferred creditor." "Transfer" is defined broadly in section 101(40) to include indirect modes of transfer.\textsuperscript{113} There is little difference between this and the old section 1(30) definition.\textsuperscript{114} Similarly, section 547(b)(1) uses the identical language contained in section 60(a), recognizing that a preferential transfer must be either "to or for the benefit of a creditor."\textsuperscript{115} The sweep of the language is the same but has greater significance in the new preference scheme. The broad definition of transfer and the inclusive concept "to or for the benefit" combine with the other generally mechanical directives of section 547(b) to produce radical results. Many more transactions will initially be defined as preferences.

"Transfer" and "benefit" within section 547(b) are particularly important concepts to understand when examining transactions common to after-acquired property financing. Obviously, payments made directly to the creditor are transfers to him. So are the continuing acquisitions of security interests in discrete items of personal property covered by the description of collateral in the security agreement. Moreover, work done to improve the collateral can be viewed as an indirect mode of transfer to the secured creditor. Additionally, transfers to third parties, although not transfers to the creditor, may be preferential to him if they are ultimately "for his benefit." Despite these various forms of "transfer," not every event which benefits the creditor will be a transfer. Although both the concepts of "transfer" and "benefi-

\textsuperscript{111} See infra text accompanying notes 143-44.
\textsuperscript{112} See infra text accompanying notes 237-94.
\textsuperscript{114} Bankruptcy Act § 1(30). See supra note 93.
\textsuperscript{115} Courts often see no distinction between indirect transfers "to the creditor" and transfers "for the benefit of the creditor." Within the context of commercial financing the conceptualization of what is transferred may sometimes make the distinction significant. See infra text accompanying note 315-18. More often the distinction is not practically significant because courts find "benefit" in all direct transfers; and transfers to third parties which benefit the creditor can be seen as indirect transfers "to" the benefited creditor.
fit” have an important relationship in the section 547 scheme, they are separate concepts. It is necessary to distinguish between nontransfer events, transfers to third parties for the benefit of the creditor, and indirect modes of transfer to the creditor.

Some events which increase the value of a security interest will be transfers; others will not. The mere appreciation of property already subject to a security interest is not by itself a transfer. This is true even if the property had been acquired during the critical period and subsequently appreciated. A transfer of security, however, does occur when the property is acquired. If that transfer is preferential, the trustee can retrieve the property at its appreciated value. 116

A direct transfer to a third party may increase the value of the security interest to the secured party, and therefore be “for his benefit.” This is distinguished from indirect modes of transfer “to the creditor” which also increase the value of his security interest. A few examples will help to illustrate this distinction. 117

CASE 1. A creditor (C) was owed $20,000 by debtor (D), secured by an interest in two drill presses, each worth $10,000 at the beginning of the ninety-day period. C had the only security interest in drill press #1. C’s security interest in drill press #2 was second in priority to a fully secured purchase money party (S). 118 S had sold drill press #2 to D before the ninety-day period began. At the outset of the critical period, S was still

116. A recent Article on § 547 concludes that a transfer in substitution would be subject to preference attack if the creditor was undersecured at the transfer and subsequent events produced an appreciation of the substituted collateral, thus improving the creditor’s position over what it would have been absent the substitution. Kaye, Preferences Under the New Bankruptcy Code, 54 AM. BANKR. L.J. 197, 200 (1980). The author correctly perceived that the elements of a preference, including § 547(b)(5), are measured as of the date of bankruptcy. See infra text accompanying notes 128-39. Acquiring the security interest in the new collateral enables the creditor to “receive more” than he would without the security interest. The creditor would “receive more” even if the collateral did not appreciate.

In Kaye’s hypothetical, however, the transfer falls within the § 547(c)(1) exception; an exception which only applies if all the § 547(b) elements are met. Nothing in the Bankruptcy Code suggests that the § 547(c)(1) exception is measured at the time of the petition. Furthermore nothing in § 547 suggests that the § 547(c)(1) exception depends on the stability of the value of the substituted collateral. To the contrary, § 547(c)(1) only requires that a contemporaneous exchange be contemplated and that the executed exchange be at least substantially contemporaneous. The focus under § 547(b) is not a comparison between the creditor’s position with old collateral and with the new. Instead, the subsection requires a comparison of liquidation positions with the substitute collateral and without it. See infra text accompanying notes 227-29.

117. For a full analysis of these illustrations under §§ 547(b), 547(c), see infra text accompanying notes 315-18.

118. See U.C.C. § 9-312(4).
owed $10,000 on drill press #2. During the critical period, the debtor completely extinguished the debt to S. Drill press #2 is still worth $10,000.

The trustee may reasonably argue that the payments to S, the purchase money party, constitute a preference to C, the junior secured party. The payment to S clearly is a transfer, but is not preferential to him, because he was fully secured at all times. He therefore has not "received more" as a result of the transfer. C, however, has clearly benefited from this transaction. His security interest in drill press #2, valueless at the outset of the ninety-day period, is now worth $10,000. C, originally partially secured, has become fully secured as a result of the payments. The payments have enabled him to "receive more" than he would have in liquidation had the payments not been made. The payments by D to S are transfers "for the benefit" of C and, because all other section 547(b) elements seem to be present, C has received an avoidable preference. C will therefore not be entitled to satisfy his debt out of drill press #2. C can reach only the $10,000 attributable to drill press #1.

On many occasions, courts employing section 60 have showed reluctance to "punish" a creditor who has benefited from a transfer to another. There was no real statutory support for this reluctance, but it was consistent with the old Act case law approach which insulated transfers to creditors who did not "behave badly." There should be no such reluctance under the new preference scheme.

The indirect mode of transfer will occur when the debtor takes action to increase the value of collateral. The debtor may transfer some of his property to third parties to pay for these improvements. These transfers might be preferences, if all section 547(b) elements are present. At the same time, the debtor has indirectly made a transfer to the secured party. This transfer may also be a preference. Consider the following illustration:

CASE 2. A debtor (D), a month before the petition, paid $1000 to repair some factory equipment which is collateral for a loan from S.

121. While all the elements of § 547(b) may be satisfied as to these direct third party transferees, these transferees may be employees or ordinary course current expense creditors who have limited protection under § 547(c)(2). See supra text accompanying notes 47-65 & infra note 318.
Without the repair, the equipment would have been worth $500. The repair increased the value to $1500.

The debtor, by raising the value of the collateral, indirectly transferred an interest in property to the secured party. This kind of transaction might not have been preferential under section 60 because of Dubay-like theories. Under section 547, the earliest the transfer will be “deemed to occur” will be at the time the value is added; the trustee can successfully seek avoidance of the transfer. Courts should resist the temptation to seek alternative protection for the secured party by narrowing the definition of transfer.

A similar analysis under section 547(b) is required when the debtor is completing work-in-process. Often a secured party will have a security interest in inventory at all stages in its manufacture. Obviously, the completed, or more complete, inventory will be more valuable. This channeling of value into the collateral is also a transfer, and likely a preference. Part or all of such a transfer may be protected from avoidance under section 547(c)(5). Whatever is unprotected ought to be avoided by the trustee.

3. “That enables such creditor to receive more . . .”

a. The New Test

Unlike the other elements of section 547(b), subsection (b)(5) does not track section 60 language. Section 547(b)(5) simply requires that

122. This transfer may not have been preferential under § 60 case law if the indirect transfer was deemed to occur before value was added because it was “so far perfected.” See supra text accompanying notes 90-101.

123. Dating of this transfer is not clearly addressed by the statute. Based on the legislative history of the work-in-process problem, Congress probably intended to date transfers for the purpose of increasing the value of inventory collateral at the time the value is added. See infra note 313. In § 547(e)(2), “takes effect” could easily refer to the time of payment for the improvements or to the time when the debtor had a contractual right to receive the improvements. In fact, the secured party could be a third party beneficiary of this contract right.

124. It is also difficult to determine whether these transfers are payments or transfers of security interests. Apparently, Congress believed, at least in cases of work-in-process, that these are transfers of security interests, because they are treated under § 547(c)(5). The phrase “to the prejudice” in subsection (c)(5) was inserted to distinguish between increases in value of the security interest caused by transfers or other expenditures of the debtor's assets and increases attributable to the fact that completed goods are more valuable. The creditor is not penalized under subsection (c)(5) for increases in value above the cost of completing the goods. When improvements take the form of repair to equipment, however, the conceptualization of the transfer as a security interest is unfair to the secured party. See infra text accompanying notes 315-18.
the transfer enable the creditor to "receive more" than he would have received in liquidation without the transfer.125 This new language is a departure from the requirement of section 60 that the transfer enable the creditor to "obtain a greater percentage of his debt than some other creditors of the same class."126 A fresh approach is expressly invited by this break from the vocabulary of section 60. The purpose of this element is to measure whether a creditor has gained an advantage by virtue of the transfer. The "greater percentage test" required a difficult analysis of creditor classification and a complex calculation.127 If followed literally, the section 547(b)(5) test is fairly simple and mechanical.

Case law specifying the precise point for measuring the improvement—the date of bankruptcy—was clearly retained. In this one instance, the legislative history is explicit.128 Unfortunately, other section 60 case law concepts, ostensibly displaced by the new language, persist in creating difficulty. Unbelievably, some courts and commentators have applied the section 547(b)(5) test in terms of the greater percentage test of section 60.129 Even more alarming is the re-emergence of

125. Section 547(b)(5) provides:

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


126. The Bankruptcy Act § 60(a)(1) provided:

A preference is a transfer, as defined in this title, of any of the property of a debtor to or for the benefit of a creditor for or on account of an antecedent debt, made or suffered by such debtor while insolvent and within four months before the filing by or against him of the petition initiating a proceeding under this title, the effect of which transfer will be to enable such creditor to obtain a greater percentage of his debt than some other creditor of the same class.

127. See 3 Collier on Bankruptcy § 60.34 (14th ed. 1977).

128. The new Code has readopted rule of Palmer Clay Prods. Co. v. Brown, 297 U.S. 227 (1936). Construing the Act's "greater percentage" test, the Palmer case held that the effect of a transfer is measured on the date of bankruptcy, not a hypothetical liquidation on the date of transfer. The Commission Bill expressly referred to the date of the petition in § 4-607(b)(3). Commission Report (pt. 2), supra note 8, at 171. This express reference was deleted in response to a recommendation by the National Bankruptcy Conference. The recommendation was viewed as "merely clarifying" other matters and was not intended to affect the substance of the Commission's incorporation of the Palmer rule. NBC Bankruptcy Act of 1975, supra note 60, at 333, 363.

the "diminution of the estate" element, conceivably derived from the "greater percentage" test. From this derivative element sprang additional case law exceptions to section 60, most notoriously the "case law net result" rule. This rule, which had doubtful validity under section 60, has been applied to section 547(b)(5).

If the preference scheme is to work fairly in the context of commercial financing, courts must apply section 547(b)(5) in a sensible way. A number of important integration questions must be addressed:

1. How are the mechanics of the "receives more" test applied to transfers incident to after-acquired property financing? When is such a secured creditor actually fully secured, so that neither payments nor acquisitions of collateral by the debtor enable him to "receive more"?

2. What relevance does the old Act "greater percentage than creditors of the same class" test have?

3. Can the "diminution of the estate" element be read into section 547(b)(5)? Should the case law net result rule ever be applied to save otherwise avoidable transfers?

b. The Concept of Full Security

As was the case under the old Act, transfers in the form of payments or additional "after-acquired" security to an already "fully" secured creditor would seem immune from preference challenge. If the creditor were truly fully secured, and if the case went to liquidation, he

class; court protected an approved affirmation); In re Conn. 9 Bankr. 431, 433-34 (Bankr. N.D. Ohio 1981) (discussed infra at note 146); In re Castillo, 7 Bankr. 135, 137 (Bankr. S.D.N.Y. 1980) (repossession of property subject to unperfected lien; not preference since no other secured creditors in class).

The Gestaldo case cites Mann, "Greater Percentage" in the Preference Section of the New Code, 86 COM. L.J. 49 (1981). In re Gestaldo, 13 Bankr. at 810. Mann suggests that the trustee will have intolerable proof problems under § 547(b)(5). Unfortunately, the author assumes that the trustee must compare the percentage recovery of the creditor with other members of his class. He also assumes that the trustee must therefore prove what percentage the other class members would receive. If § 547(b)(5) is correctly and literally applied, the trustee's proof problems should be considerably eased. See, e.g., In re Hale, 15 Bankr. 565, 567 (Bankr. S.D. Ohio 1981). See also D. Epstein & J. Landers, Debtors and Creditors 468 (2d ed. 1982).

130. See infra text accompanying notes 161-207 & note 167.


would not receive more because of the transfer. The secured party could claim only the amount of his debt as determined and apportioned by section 506.133 In other words, the transfer of additional collateral would best be viewed as superfluous.

The concept of full security, however, is not as simple as it seems. For example, a creditor may appear to be fully secured at the time any discrete transfer is made to him. Nevertheless, he may have been undersecured at the beginning of the ninety-day period and have achieved “fully secured” status only by virtue of other preferential transfers made during the period. Similarly, the value of the collateral might have remained above the debt at all times, but the particular items of collateral may have turned over substantially, or even completely, during the period. If the transfers of security interests in the newly acquired collateral are avoidable, the creditor’s apparent “fully secured” position at any time might be “preference-built.” Such creditors are not fully secured for purposes of applying the section 547(b)(5) test. Consider the following illustration.

CASE 3. On January 1, a secured party (S) entered the ninety-day period with a security interest in two of debtor’s (D) machines, worth $50,000 each, as well as a security interest in after-acquired machines. D owed S $150,000 at that time. On February 1, D acquired a new machine, also worth $50,000. On March 1, D acquired another $50,000 machine, raising the total value of collateral within the grant of the security agreement to $200,000. There were no further acquisitions and no payments as of April 1 when a petition was filed.

Is the last transfer of collateral on March 1 protected from a section 547(b) challenge because the creditor would not “receive more” within the meaning of section 547(b)(5)? The secured creditor might argue that the trustee has the right to recover collateral transfers only to the point where the value of collateral becomes equal to the debt. Just before the March 1 transfer, the debtor had rights in collateral worth $150,000, and the debt was for the same amount. After that, section 547(b)(5) envisions no additional recovery, the argument continues, because subsequent transfers are to a fully secured creditor. In reality, however, the creditor’s fully secured position is “preference built,” and both subsequent transfers do improve the creditor’s liquidation posi-

133. Section 506 of the Code allows a secured party to reach collateral to the extent of his claim plus interest on such claim, costs, and other charges provided for in the security agreement. The trustee first deducts the reasonable, necessary costs of preserving or disposing of the collateral.
tion. In Case 3, the February 1 acquisition is clearly avoidable as a transfer of a security interest to an undersecured creditor. Therefore, before the March 1 acquisition is considered, S would be entitled to only $100,000 in collateral on liquidation. S would still have an unsecured claim for $50,000 as a result of the avoidance of the security interest in the machine acquired on February 1. If the March 1 transfer is protected because the creditor was apparently fully secured, the creditor would receive a liquidation interest in three machines with a value of $150,000. He would become fully secured in bankruptcy by receiving interests in collateral in two stages. In the first stage, the acquisition of collateral extinguishes the gap between debt and security. In the second stage, additional, apparently “extra,” collateral is acquired. Section 547(b)(5) was not designed to sanction this result attained through an “over-improvement” of position, whether or not intentional. The creditor whose apparently fully secured position was built by prior preferential transfers should never be able to protect subsequent additional transfers by ignoring the effect of section 547(b)(5) on prior transfers. The literal language of section 547(b)(5) does not sanction this unintended result, since the creditor does “receive more” with the March 1 transfer than without it.

The intended result becomes more clearly supportable if we measure “full security” at bankruptcy rather than at the time of transfer. From this vantage point, the trustee can discard all preferential transfers and determine whether a fully secured position is preference built or not. In Case 3, the February 1 transfer is clearly avoidable, and therefore the March 1 transfer is to an undersecured creditor. Of course, the same result could be achieved, with less clarity, by applying a time of transfer test, as long as the February 1 transfer is considered first and treated as avoidable when the March 1 transfer is analyzed. Examining prior transfers in the critical period, however, is only one of the problems of applying the section 547(b)(5) test. Events subsequent to any particular “subject” transfer are also important. Testing effect at the time of transfer cannot take account of these events.

Other cases can be easily envisaged in which apparently superfluous transfers of collateral to an already fully secured creditor become im-

134. The acquisition of the machine is a transfer within the 90-day period under § 547(e)(3). If the transfer had not been made, the creditor would not have been fully secured, but would have had a $50,000 unsecured claim. The transfer obviously enabled him to “receive more.” All other § 547(b) elements are apparently satisfied.
important because of the subsequent loss of collateral. A time of transfer test would require a determination of whether the creditor "received more" than his entitlement in a hypothetical liquidation without the transfer on the date of the transfer. On the other hand, if the date of petition test is applied, section 547(b)(5) is satisfied if events after transfer and before the date of the petition enable the secured party to receive more in the actual liquidation. Consider the following illustration:

CASE 4. On January 1, at the beginning of the ninety-day period, the secured party (S) had an interest in both D's existing and after-acquired machines. At that time, D had two machines worth $50,000 each and owed S $100,000. On January 2, D acquired a third machine, also worth $50,000, raising collateral value to $150,000. No further transfers occurred before the date of the petition. Due to an industry-wide technological breakthrough, however, the machines are worth only $30,000 each on the date of the petition.

Does the transfer on January 2 enable the creditor to "receive more" under the section 547(b)(5) test? The creditor appeared to be fully secured when the transfer was made. A hypothetical liquidation at time of transfer would indicate that the secured creditor did not "receive more." Although the time of transfer will be relevant in determining if the transfer is for antecedent debt or whether the transfer might be saved by certain exceptions in section 547(c), it is not relevant to the application of the section 547(b)(5) test. The actual effect on the date of bankruptcy is the focus of section 547(b)(5). In Case 4, the creditor's real position was improved by the transfer. If the transfer had not occurred he would have had $60,000 in collateral and an unsecured debt for the $40,000 balance. With the transfer he has $90,000 in collateral and an unsecured debt for only $10,000.

The language of section 547(b)(5) suggests, and the legislative history clearly indicates, that the creditor "receives more" if his liquidation position on the date of bankruptcy is improved. The creditor's position as a result of the transfer is compared with what the creditor would receive if "the transfer had not been made and such creditor received payment to the extent provided by this title." Although Congress

135. For example, § 547(e)(1) will only apply if the transfer is substantially contemporaneous with the new value given. See infra text accompanying notes 240-42.

136. 11 U.S.C. § 547(b)(5)(B), (C) (Supp. V 1981). The extent that a creditor would receive payment as "provided by this title" can only be determined as of the date of petition.
abandoned the "greater percentage" test for measuring creditor advantage, it intended to readopt the rule in Palmer Clay Products Co. v. Brown. 137 The opinion in Palmer Clay Products directly addressed this issue. A preference was measured not by assuming a liquidation and distribution at the moment of transfer, but by its actual effect on creditors in the bankruptcy which followed. Despite the absence of an express statement in section 547(b)(5), the timing standard in Palmer Clay Products was cited approvingly as the new preference section was developing. 138 Through all the mechanical changes leading to the "receives more" test, nothing in the legislative history suggested a departure from the Palmer Clay Products standard. 139

Furthermore, utilization of the time of transfer test, as opposed to the date of petition test, theoretically increases the creditor's vulnerability in a way that could never have been intended. If section 547(b)(5) speaks to date of the petition, only transfers of specific property or the proceeds of that property still held by the debtor at bankruptcy enable the secured creditor to "receive more." If in Case 4, the third machine had been sold with the creditor's authorization, and the proceeds had been squandered, the creditor would have lost his security interest in both the machine and identifiable proceeds. The creditor would not "receive more" in the actual liquidation as a result of the transfer. Even in the unlikely event that ordinarily stable collateral, like equipment, turned over several times during the preference period, the trustee under the date of petition test could only avoid transfers of collateral still retained by the debtor on the date of bankruptcy. Under the time of transfer test, however, a secured creditor who did not police the proceeds might be liable for more than the value of property on hand. Consider the following illustration:

CASE 5. On January 1, the debtor (D) enters the ninety-day period with two machines worth $50,000 each securing a debt to S. On this date D owed $150,000. On January 2, D purchases a third machine worth $50,000. D becomes dissatisfied with this machine. In February, D sells the machine with S's permission, but squanders the proceeds. On March

137. 297 U.S. 227 (1936).
139. See supra note 128. Moreover, a spokesman for the Conference specifically referred to this change in his statement to a House Subcommittee. His comments expressly recognize, without criticism, the fact that the "test is to be applied as of the date of the petition." 1976 House Hearings, supra note 43, at 1841-42 (statement of Leon Forman on behalf of the National Bankruptcy Conference).
1, a fourth machine worth $50,000 is purchased. On April 1, the petition is filed.

If the time of transfer test is applied, a $50,000 preference occurred on both January 2 and March 1. In both cases, a security interest worth $50,000 was transferred to $S$, who was undersecured at the time of transfer. This sequence could continue as long as new collateral was acquired and old collateral sold off. Under this erroneous application of the section 547(b)(5) test, the creditor’s initial liability could conceivably be limitless. However improbable, the result is a logical extension of an incorrect test which in reality would work more often to the creditor’s benefit. All applications of the time of transfer test would be radical departures from any past or present concept of preferential transfers.

Preserving the date of bankruptcy as the focus of the “receives more” test is essential in the integration of the new preference section. Properly viewed, the section 547(b)(5) test permits a remarkably simple classification of all collateral transfers which occur during the critical period.

All collateral acquired by the debtor during the ninety-day period will enable the creditor to “receive more” as long as the collateral is still present in its original form or as identifiable proceeds, and claimed by the secured creditor as necessary to satisfy his debt. Thus, only in a narrow set of circumstances will transfers of collateral during the critical period fail to meet the section 547(b)(5) test. First, the creditor must be fully secured at the beginning of the period. Second, he must hold so much of the same collateral or its identifiable proceeds at bankruptcy so as to equal or exceed his maximum possible secured debt as it is adjusted upwards if preferential payments are recaptured. Under

140. In Case 5, the time of transfer test would have benefited the creditor in a manner inconsistent with the new preference scheme. At the time of acquisition of the third machine, the creditor was fully secured. Focusing on that date, there is no preference even though the third machine enables the creditor to “receive more” in the actual bankruptcy liquidation.

141. The maximum possible claim is the creditor’s total adjusted claim after he has returned preferential payments and includes any expenses allowed by § 506. This calculation may appear to be difficult because payments will not enable the creditor to receive more if he is fully secured. Moreover, some payments might be unavoidable because of § 547(c) exceptions. Unless some ordering principle is applied, the trustee is caught in a circle. A payment is a preference if the creditor is undersecured. A creditor is undersecured if collateral is insufficient to meet his claim after the claim has been adjusted to take into account the return of preferential payments. The circle is broken by first assuming all payments will have to be returned. This gives a number equal to the largest potential claim. This number is used to determine which acquisitions of col-
these circumstances, the transfers are not preferential because resort to
the collateral is unnecessary to satisfy the creditor's claim.

The application of the section 547(b)(5) test in all other cases is
merely axiomatic. Any security interest transferred during the critical
period and necessary to satisfy the creditor's claim obviously enables
him to receive more than he would have received without the transfer.
Without the transfer, that portion of debt now secured by the “suspect”
security interest would be unsecured.\footnote{142}

Many transfers, preferential under section 547(b), will nevertheless
be unavoidable because of the exceptions in section 547(c). For exam-
ple, if in Case 4 the collateral had been accounts or inventory instead of
equipment, the ultimate result would have been different. The transfer
of the security in the final $50,000 in collateral satisfies all the elements
of section 547(b), including subsection (b)(5).\footnote{143} The transfer, however,
would nonetheless be unavoidable because of the section 547(c)(5) ex-
ception.\footnote{144} This is the way the section was designed to operate.

c. Displacing the “Greater Percentage” Test

As has been indicated,\footnote{145} the measure of improvement in section 547
lateral are superfluous. Possible \S 547(c) exceptions insulating transfers of collateral are then ap-
plied. After the trustee first determines what collateral is actually available, he may then claim
that all payments which apparently reduced the debt below the value of unavoidable security
interests “enabled the creditor to receive more.” Except to the extent that the \S 547(c) exceptions
save some of those payments, they will be avoidable by the trustee. For an explanation and illus-
tration of this ordering, see infra text accompanying notes 208-14.

Of course, this discussion realistically assumes the creditor would not receive 100\% of his un-
secured claim in a Chapter 7 liquidation. See D. Epstein & J. Landers, supra note 129, at 468.

\footnote{142} This is true even when the transfer of collateral is saved by a \S 547(c) exception. Argua-
bly, application of the “receives more” test might be read to require a premature application of
\S 547(c) in order to make the comparison envisioned by \S 547(b)(5). Section 547(c), however,
only applies to transfers already found preferential under \S 547(b). This apparent circularity is
not mandated and should not undermine the clear, inclusive test proposed by \S 547(b)(5). See
infra text accompanying notes 215-23.

\footnote{143} Again, the assumption is the creditor would not receive 100\% of his unsecured claim in
Chapter 7 liquidation.

\footnote{144} This result is required under \S 547(c)(5) because there was no gap between the value of
collateral and the debt at the beginning of the critical period. There could, therefore, be no im-
provement of position by decrease in this gap under the \S 547(c)(5) test. Section 547(c)(5) ignores
fluctuations during the period and merely compares the extent that the creditor is undersecured—
the gap—at the beginning of the period with the gap on the date of the petition. Transfers of
security in inventory or accounts may be avoided only if they cause the gap to decrease. For a
more complete explanation of the \S 547(c)(5) exception and its mechanics, see infra text accompa-
nying notes 296-319.

\footnote{145} See supra text accompanying notes 125-44.
is a "receives more" test which no longer refers to either "greater percentage" or "creditors of the same class." Encouraged by language from the House and Senate Reports, however, these old Act concepts linger on in the cases and literature. While this confusion would not be critical in most cases, a careful examination of the development of the present section 547(b)(5) language points to a change in the focus of the test for creditor improvement. Most significantly, the comparison of the present test is far less confusing than the comparison necessitated by the "class" standard as developed in section 60 case law.

A major cause of the change from the old Act language was an anomalous result that occurred when the class analysis was used. Under the old Act, a creditor, such as a landlord, might have received a payment which enabled him to receive a greater percentage than creditors of a higher class. If he was the only creditor in his own class, however, the transfer could not be called a preference. The new language clearly avoids this result.

The new language of section 547(b)(5) no longer requires a comparison with other members of the same or other classes. Rather, the subsection calls for a simple comparison of the creditor’s liquidation positions with the transfer and without the transfer. Unless the creditor would be entitled to a 100% recovery in liquidation, or 100% of that portion of the debt represented by the transfer, the transfer will have enabled him to receive more.

Although not used for the standard of comparison in section 60(a), the reports use the language "greater percentage of his claim" to describe the key calculation in § 547(b)(5). This is an unfortunate choice of words. It suggests the continued validity of the § 60(a) test. See Senate Report, supra note 12, at 87; House Report, supra note 12, at 372. The commentators have relied on this language. See 4 COLLIER ON BANKRUPTCY ¶ 547.35 (15th ed. 1982); Mann, supra note 129; Young, Preferences Under the Bankruptcy Reform Act of 1978, 54 AM. BANKR. L.J. 221 (1980); Levin, An Introduction to the Trustee's Avoiding Power, 53 AM. BANKR. L.J. 173(1979). Many cases have also relied on the language. See In re Music House, Inc., 11 Bankr. 139 (Bankr. D. Vt. 1981); In re Conn. 9 Bankr. 431 (Bankr. N.D. Ohio 1981); In re Castillo, 7 Bankr. 135 (Bankr. S.D.N.Y. 1980).

In re Conn is another in a series of inexplicable decisions declaring that installment payments to an undersecured creditor during the critical period were not preferences. In Conn, the court stated that the trustee had failed to meet his burden of proof. According to the court, he had failed to show that an Oldsmobile Omega purchased used nearly a year before bankruptcy was not worth $300 more on the date of petition than when first purchased.

Theoretically, the same result could have occurred if all creditors of a class were equally preferred. The reported cases do not indicate that this anomaly caused any problem. The problem caused by the literal language, however, was addressed in both the Commission Bill and the Judges' Bill, § 4-607(b)(3).

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547(b)(5), reference to the priority categories in section 507 may be important in determining what an individual would have received in a Chapter 7 liquidation had the transfer not been made. Consider the following illustration:

CASE 6. D has fallen behind in paying his employees. One key employee (A) threatens to resign if not paid on July 25. A receives $2000, his salary for the month of June. On August 1, D files a voluntary petition.

Under section 507, wage, salary and commission claims up to $2000 are in the third level of priority. 148 If the estate has assets sufficient to fully satisfy these limited third-priority wage claims, then A would have received the $2000 anyway. He has not, therefore, “received more,” so there is no preference. A would be preferred if the assets of the estate were insufficient to satisfy wage claims up to $2000. Since he would have received less than the full $2000 in the Chapter 7 proceeding, the transfer enabled him to receive more. He would have been preferred even if there were no other wage claimants so long as the assets of the estate would be depleted before A’s third-priority claim could be paid in full. In that case, A would have received less than $2000 in the actual Chapter 7 liquidation.

Because of the $2000 limit on third-priority wage claims, it is possible that A, the hypothetical employee, could receive a greater percentage of unpaid wages than members of his class, and still not be preferred. 149 In fact, the present language makes this clearer than the language of section 60(a). 150 For example, suppose A’s wage claim

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148. Section 507 does not use the term “classes;” neither did § 64 under the old Act. Since § 60 referred to classes, these priority categories became known as classes. Swarts v. Fourth Nat’l Bank, 117 F. 1 (8th Cir. 1902). Since § 547(b)(5) does not refer to classes, there is no reason to refer to the priority categories of § 507 as such. The practice is likely to continue, however, because of the language in the House and Senate Reports. See supra note 146.

149. See also Levin, supra note 146, at 190 (transfer of property to a consumer who has made a prior deposit, § 507(a)(5)).

150. The National Bankruptcy Conference first suggested that the class comparison language be dropped. The Conference proposed the following language in its stead: “The result of the transfer does not enable the creditor benefitted to obtain a greater percentage of his claim than he would be entitled to under the distributive provisions of this Act.” Resolutions of the National Bankruptcy Conference, Annual Meeting, 1975, reprinted in 1976 House Hearings, supra note 43, at 1848. See also NBC Bankruptcy Act of 1975, supra note 60. The Conference stated that the Commission language in § 4-607(b)(3) was “unclear as to whether all payments on liens and priority claims are to be deemed preferential, even though such claims may be reached in bankruptcy distribution.” 1976 House Hearings, supra note 43, at 1841–42 (statement of Leon Forman on behalf of the National Bankruptcy Conference).

Note that both the Commission Bill and the Conference redraft considered all transfers during
would have been $2000 had he not received the transfer. Suppose other wage claimants have $3000 wage claims. If the assets of the estate were sufficient to satisfy all section 507(a)(3) wage claims, each claimant would receive $2000. If the estate is depleted before unsecured creditors are completely paid, the wage claimants other than $A$ will receive less than 100%. $A$, on the other hand, had only a $2000 claim, which would be fully satisfied in Chapter 7 liquidation. Therefore, although he has received a greater percentage than other wage claimants, $A$ has not been preferred. Under the "receives more" test, he is no better off with the transfer than he would be without it.

The misleading language in the House and Senate Reports is in part attributable to the fact that earlier drafts retained the "greater percentage" test and merely added the language requiring a comparison to the higher classes. This narrow approach was abandoned on the recommendation of the National Bankruptcy Conference, which concluded that the section should be clarified by a simple comparison test. The Conference substituted language to indicate that there could be no preference if the creditor would be entitled to the same payment in liquidation due to a valid lien or priority claim. This clarification was made necessary because of a possible misapplication of the "greater percentage" test under which the trustee theoretically could recapture payments only to return the same amount to the creditor in liquidation. After this clarification, the focus of the section was no longer a comparison with other "class" members but a comparison of liquidation positions with and without the transfers. All subsequent

the critical period to be preferences. A payment which did not result in a creditor obtaining "a greater percentage" was an exception to the definition of a preference. The first congressional redraft, H.R. 6, the so-called "compromise bill," retained the liquidation comparison test, but substituted the "receives more" language for the "greater percentage" language. Otherwise, the changes in language are merely stylistic. This test, however, was reincorporated in the definition of a preference, restoring the burden of proof on this element to the trustee. See supra note 76.


152. The date of the bankruptcy is the proper time for the comparison. See supra text accompanying notes 136-39.

153. The Commission & Judges' Bills, § 4-607(b)(3), made a transfer avoidable unless the creditor received no "greater percentage of his claim than other creditors of the same class and there are no unpaid creditors of a higher class."

154. See supra note 150.


156. Id.
drafts contained the "receives more" language.\textsuperscript{157}

Although this new emphasis may not change the result in most cases, it should not be ignored. Despite the House and Senate Reports, the literal language of section 547(b)(5) and the context in which that language was chosen should be controlling.\textsuperscript{158} Undue emphasis on these reports would be unfortunate in those cases where the new standard—the clean, mechanical comparison required by section 547(b)(5)—is critical to the outcome.\textsuperscript{159}

Moreover, there are compelling reasons to abandon the "greater percentage" test. This test was the source of much of the contorted case law which undermined the equality of distribution principle under the old Act. The "greater percentage" test is often considered the statutory basis for the phantom element of section 60: the necessity for an overall "diminution of the estate." This element, in turn, when combined with certain fictions, gave rise to a gradually expanding case law net result rule. As the next section of this Article demonstrates, this element, and more specifically, the case law net result rule, are eliminated from the new preference scheme. Nonetheless, courts are still using this element to create exceptions through section 547(b) not specified in section 547(c).\textsuperscript{160} The overall integrity of the preference scheme might better be assured if preference questions were analyzed without resort to unnecessary and unwarranted section 60 language.

d. "Diminution of the Estate"

The section 60 case law concept most destructive to the new integration was born in the most innocent of contexts. The original 1898 version of section 60 required, as a condition to the avoidance of a preference, that the transferee have a "reasonable cause to believe that
it was intended thereby to give a preference." At the same time, section 57(g) required the creditor to return all preferences, whether or not they were avoidable, before his claims against the estate would be "allowed." This resulted in particular hardship to the running accounts creditor, who often received many unavoidable preferential payments during the four-month period.

This silly and unfortunate rule was eventually rectified by Congress. By the time Congress acted, however, the courts had already intervened on behalf of the beleaguered running accounts creditors. Since all section 60(a), or so-called "technical," preferences had to be returned, the courts sought to take these payments out of the section 60(a) definition altogether. Courts read into section 60(a) a requirement that there be a net "diminution of the estate." This requirement seemed to be tied to the language of the "greater percentage test," although some language in the opinions also related to the "antecedent debt" requirement. In most of the cases, the response to the section 57(g) problem was a measured one. The technical preference that the creditor was required to refund was reduced only by subsequent credit extensions. The First Circuit, however, adopted a broad approach to the section 57(g) problem which the Supreme Court ultimately adopted.

The First Circuit and Supreme Court chose to treat all transactions between the debtor and running accounts creditor which occurred during the critical period as a single transaction. Providing relief from sec-

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161. See supra notes 2 & 4.

162. As originally enacted, § 57(g) of the 1898 Act provided that "the claims of creditors who have received preferences shall not be allowed unless the creditors shall surrender their preferences." Act of July 1, 1898, ch. 541, § 57(g), 30 Stat. 544 (current version at 11 U.S.C. § 502(d) (Supp. V 1981)).


164. See, e.g., C.S. Morey Mercantile Co. v. Schiffer, 114 F. 447, 448-49 (8th Cir. 1902); Kimball v. Rosenham Co., 114 F. 85, 88 (8th Cir. 1902).

165. The reasoning of these cases varied. Some courts read § 60(a) and § 60(c) together in an attempt to define the creditor's § 57(g) responsibility to return a technical preference. Because § 60(c) provided for credit against preferential payments only to the extent of subsequent credit remaining unpaid, only subsequent credit was considered in mitigation of the rigor of old § 57(g). Gans v. Ellison, 114 F. 734, 736 (3d Cir. 1902); McKey v. Lee, 105 F. 923, 925 (7th Cir. 1901).

166. Jaquith v. Alden, 189 U.S. 78 (1903), aff'd 118 F. 270 (1st Cir. 1902). The reasoning was originally set out in Dickson v. Wyman, 111 F. 726 (1st Cir. 1901), although the limitation of the "set-off" to subsequent extensions of credit was not specifically abandoned until In re Topliff, 114 F. 323 (D. Mass. 1902). The issue was again raised in the lower court opinion in Jaquith and the abandonment of the limitation was sustained by the First Circuit. 118 F. at 271.
tion 57(g), the courts abandoned the limitation based on credit extended after payment, a limitation which was consistent with the premise of section 60(c). The creditor could utilize all credits during the critical period to offset payments, and only the excess of payments over credits were technical preferences subject to return under section 57(g). This "net result rule," was logically tied to the "greater percentage" test. 167 If there was "no diminution of the estate" by the total transactions within the critical period, the payments did not enable the creditor to receive a "greater percentage . . . than any other creditor of the same class." 168

All the early federal cases, including the Supreme Court case, had two elements in common. First, each case involved a running accounts creditor. Second, in none of the cases had the trustee proved the "reasonable cause to believe" required by section 60(b) for trustee avoidance. 169 As a result, the original case law net result rule addressed only the technical problem of the running accounts creditor under section 57(g) and affected only payments which the trustee could not have ultimately avoided. The innocence, if not the integrity, of the rule was maintained.

Although the basis of these cases became obsolete after the 1903 amendment to section 57(g), these cases had two lasting effects on section 60. 170 First, "diminution of the estate" made its way into the vo-

167. To the extent that the debtor's payments result in the creditor's subsequent decision to extend credit, the payments can be analogized to the cash purchase of goods by the debtor. The debtor is purchasing the opportunity for future credit extensions. The payments would not be "for an antecedent debt" to the extent that they actually "bought" subsequent extensions. See, e.g., Kimball v. E.A. Rosenham Co., 114 F. 84, 88 (8th Cir. 1902). This reasoning has led some commentators to tie the "diminution of the estate" requirement, at least in part, to the antecedent debt element of a preference. See 3 COLLIER ON BANKRUPTCY § 60.20 (14th ed. 1976). The problem with this tie-in is obvious when there is an excess of payments over credits. If the payments are not for antecedent debt, not even the excess would have to be returned. The statute, however, clearly required such excess be returned. See, e.g., Gans v. Ellison, 114 F. 734 (3d Cir. 1902).

168. Dickson v. Wyman, 111 F. 726, 728 (1st Cir. 1901).

169. At that time, the trustee had to prove that the transferee had reasonable cause to believe a preference was intended. See supra text accompanying note 161. In a case in which a creditor gives credit and receives payments in the normal pattern, proof of this element, absent an admission, would have required extraordinary evidence of the creditor's knowledge of the debtor's purpose. The purpose of the "net result" fiction was to protect running accounts creditors to whom payments were rarely avoidable.

170. See supra note 163. In two subsequent cases, the Supreme Court utilized the rule in Jagust v. Alden. Both cases, however, arose from bankruptcies governed by the preamendment version of § 57(g). See Joseph Wild & Co. v. Provident Life & Trust Co., 214 U.S. 292 (1909); Yapele v. Dahl-Millikan Grocery Co., 193 U.S. 526 (1904). The latter case is interesting because
ocabulary of the section 60(a) definition of a preference. For some time after the 1903 amendment, case law insistence on a “diminution of the estate” remained innocent and basically harmless. In most cases, the element is merely an obvious restatement of the greater percentage test—when the creditor gets more, the estate gets less. For example, the element was most often utilized to protect transfers that were obviously not preferences, such as payments in exchange for the release of valid liens or payments to which the creditor would be otherwise entitled under section 64.\textsuperscript{171} This element, however, also provided a convenient device for protecting other transfers deemed worthy by the courts even though such transfers seemed to fit the explicit section 60(a) definition of a preference.\textsuperscript{172}

The second related effect was the continued use of the net result rule despite the amendment to section 57(g).\textsuperscript{173} Here again, in nearly every case, resort to the rule was unnecessary, largely because the trustee had not proved that the creditor had “reasonable cause to believe in the debtor’s insolvency.”\textsuperscript{174} For a time, application of the rule was limited

the Supreme Court overruled the Third Circuit which was apparently dissatisfied with the rule in \textit{Jaquith} and seized upon the fact that the last transaction in that case was a sale of goods on credit for $182.70. This followed a payment of over $534.78. The court attempted to limit the \textit{Jaquith} rule to those cases where the last transaction between the parties was a credit, however small. Joseph Wild & Co. v. Provident Life & Trust Co., 153 F. 562 (3d Cir. 1907), aff'd 146 F. 142 (E.D. Pa. 1906). The Supreme Court rejected this desperate attempt to limit the breadth of \textit{Jaquith}. 214 U.S. at 297.


174. Farmers Bank v. Julian, 383 F.2d 314 (8th Cir.), cert. denied, 389 U.S. 1021 (1967); \textit{In re Fred Stern & Co.}, 54 F.2d 478 (2d Cir. 1931); \textit{In re Grocers’ Baking Co.}, 266 F. 900 (M.D. & N.D. Ala. 1920), aff’d sub nom Eggleston v. Birmingham Trust & Sav. Co., 277 F. 1015 (5th Cir. 1921); Dunlap v. Seattle Nat’l Bank, 93 Wash. 568, 161 P. 364 (1916). Although recognizing its significance as precedent, Learned Hand twice commented on the lack of a rational basis for the rule. In reference to the three Supreme Court cases, he stated, “I am not sure that I understand on what
to running accounts cases, although some courts later "deemed" other credit arrangements analogous to running accounts and applied the rule.\textsuperscript{175}

The expansion of the net result rule reached an unprecedented level in \textit{Farmers Bank v. Julian}.\textsuperscript{176} The application of the rule was unnecessary in that case, because the creditor, a bank lending against the debtor's equipment, had no knowledge or notice of the debtor's insolvency.\textsuperscript{177} Nonetheless, the court in clear dictum stated that the net result rule would have applied even if section 60(b) had been satisfied. Notably, the creditor was not a running accounts creditor, but rather an installment lender which received a $12,000 preference, but subsequently advanced $16,000.\textsuperscript{178} This is precisely the kind of case in which section 60(c), the so-called \textit{statutory} net result rule, was meant to apply.\textsuperscript{179} Section 60(c) limited the amount that could be set off against principle those cases rest, but I cannot distinguish them on the facts." Federal Int'l Banking Co. v. Childs, 54 F.2d 478, 481 (2d Cir. 1931) (Hand, J., concurring). In \textit{Childs}, the trustee failed to meet his burden of proof under § 60(b). In dictum in a later case which did not apply the rule, Hand stated. "[t]he doctrine is somewhat anomolous at best, and can be defended in principle only by the fiction of treating all items of the account as one. . . ." Wilcox v. Goess, 92 F.2d 8 (2d Cir. 1937), \textit{cert. denied}, 303 U.S. 647 (1938) (emphasis added).

\textsuperscript{175} Farmers Bank v. Julian, 383 F.2d 314 (8th Cir.), \textit{cert denied}, 389 U.S. 1021 (1967); \textit{In re Stewart}, 233 F. Supp. 89 (D. Or. 1964); Dunlap v. Seattle Nat'l Bank, 93 Wash. 568, 161 P. 364 (1916) \textit{Stewart} was a variation of a running accounts arrangement. The debtor and creditor agreed that the creditor would not deliver more gasoline to the debtor until the debtor paid for a prior load. This arrangement was entered into after the creditor became aware of the debtor's financial problems. This is not a "like-cash" transaction typical of the running account credit arrangement. This was a conscious arrangement of additional credit in exchange for a payment of an existing debt, an ideal case for § 60(c) treatment. The court found no reason to reach the question of the applicability of § 60(c). 233 F. Supp. at 93.

The \textit{Dunlap} case involved the accounts of the bankrupt bank with another bank. The court analogized this to a "mutual running account." Once again, § 60(c) would have been a proper route, with the overdraft withdrawals of the bankrupt qualifying for § 60(c) treatment. 93 Wash. at 580, 161 P.2d at 369. For a discussion of the \textit{Julian} case, see infra text accompanying notes 176-85.

\textsuperscript{176} 383 F.2d 314 (8th Cir.), \textit{cert denied}, 389 U.S. 1021 (1967).

\textsuperscript{177} \textit{Id.} at 326-27.

\textsuperscript{178} The debtor paid back $9000 on account of the $12,000 loan. When the $16,000 advance was made, $3000 was applied to the antecedent debt. \textit{Id.} at 326.

\textsuperscript{179} The Bankruptcy Act §60(c) provided:

\begin{itemize}
  \item If a creditor has been preferred, and afterward in good faith gives the debtor further credit without security of any kind for property which becomes a part of the debtor's estate, the amount of such new credit remaining unpaid at the time of the adjudication in bankruptcy may be set off against the amount which would otherwise be recoverable from him.
\end{itemize}

Because of limitations on the set-off, § 60(c) was not really a "net result rule," but the name has been consistently applied. There has been understandable confusion because of the attention
recoverable preferences to new credit advanced after the preferences. 180 The amount of this set-off was further limited to the subsequent advances which remained unpaid. 181 In this case, an allowable section 68 set-off reduced the “credit remaining unpaid” under section 60(c) to approximately $6000. 182 The trustee therefore claimed that the remaining amount of approximately $6000 was still avoidable. Dissatisfied with the extent of the relief provided by section 60(c), the court applied the more generous case law net result rule. 183 The court reasoned that the subsequent advance was made only because the debtor made the preferential payment. Since the advance was greater than the preference, the estate was not diminished. The opinion in Julian also extended the case law net result rule beyond the running accounts creditor. The court justified this extension on the grounds that “the equitable principles that would govern that class of cases” were equally applicable to a loan payment and subsequent advance. 184 The new extension of credit was prompted by the prior payment, and no doubt the lender assumed the payment valid. The statutory formula in section 60(c) was designed to apply to this very situation. The fact that the court or creditor was dissatisfied with the amount “saved” by section

given to the case law “net result rule” derived from Jaquith. The confusion could be avoided by referring to the statutory rule as simply § 60(c). Because the cases and literature use the “net result rule” label, however, confusion is avoided by reference to either the “case law net result rule” or the “statutory net result rule.”

180. Id

181. This requirement led to some injustices. The basic theory is sound, because if the advances were paid back, the creditor did not redeem prior preferences by restoring the money to the estate. Unfortunately, the payment on these advances might also have been preferential. The trustee would argue that the new credit did not remain unpaid, yet at the same time seek return of those payments as preferences. See Grandison v. National Bank of Commerce, 231 F. 800 (2d Cir.), cert. denied, 242 U.S. 644 (1916) (trustee successfully advanced this argument). Contra In re Ace Fruit & Produce Co., 49 F. Supp. 986 (S.D.N.Y. 1943). For an excellent discussion of this problem and other accounting problems under § 60(c), see Note, The Proposed Amendment to Resolve the “Remaining Unpaid” Paradox of Section 60c of the Bankruptcy Act, 64 Yale L.J. 293 (1954). These problems have been eliminated under § 547(c)(4). See infra text accompanying notes 284-89.

182. Section 68 of the Act allowed mutual debts and credits between the bankrupt to be set off against the other. The set-off should not be confused with § 60(c), which allowed a set-off against the amount of recoverable preferences to the extent of subsequent advances which remain unpaid. In Julian, the availability of a § 68 set-off reduced the amount of new credit that remained unpaid under § 60(c).

183. 383 F.2d at 327. Note that the “injustice” was caused by the “remaining unpaid” language of § 60(c), not the requirement that advances be subsequent to the preferences.

184. Id at 328.
60(c) seemed meager justification for the nonstatutory net result rule.\textsuperscript{185}

There is substantial mischief in the extension of the “diminution of the estate” element and its corollary case law net result rule beyond the original justifications. Any court can extend these devices to any set of facts if it desires to save a transaction it deems worthy. In fact, some courts have indicated a willingness to go beyond the net result rule and create an additional exception based solely on the derived element of “diminution of the estate.” These courts seemed to indicate that the estate is not diminished if payment is made to a creditor whose role is crucial to “the ability of a business to operate and thereby, at a minimum preserve the value of its assets for all creditors.”\textsuperscript{186} In some of the

\begin{footnotesize}
\textsuperscript{185.} One commentator has taken the position that a court should apply the case law net result rule when dissatisfied with § 60(c). Taylor, Section 60(c) of the Bankruptcy Act: Inadequate Protection for the Running Account Creditor, 24 VAND. L. REV. 919, 923 (1971). Although the application of the rule seems clearly improper when defended on that ground, the court in Julian relied on this justification.

\textsuperscript{186.} See, e.g., In re National Home Prods., 4 BANKR. CT. DEC. (CRR) 1295 (E.D. La. Nov. 6, 1978) (utility payments). The court rejected a Sixth Circuit decision, In re Columbus Malleable, 459 F.2d 118, 121 (6th Cir. 1972), which had correctly stated that the estate is diminished whenever a creditor received a larger percentage than creditors of the same class. The estate is diminished because it has less than it would have had if the preference were recovered. In order to circumvent this fact, a court must indulge some fiction. In the original case law net result rule opinions, the courts treated a number of payments and credits as a single transaction. Other courts have distorted the “greater percentage” test by use of a unique hindsight device. These cases have held that a transfer does not diminish the estate if in hindsight the transfer enabled the debtor to continue his business or obtain further credit from the transferee. The theory here seems to be that if the creditor had known the payment would be avoided, he would have defaulted the debtor and ceased doing business rather than pursue the course actually taken. See 4 BANKR. CT. DEC. (CRR) at 1297-98; Farmers Bank v. Julian, 383 F.2d at 327-38.

Recently, a court has misapplied § 547(b)(5) by resort to the same type of hindsight. See In re Bullen, 11 Bankr. 440 (Bankr. W.D.N.Y. 1981). The creditor, GMAC, had received installment payments on a car loan during the critical period. The court reasoned that the creditor did not receive more because if the payments had not been made, the creditor would have repossessed the car at an earlier time, when it was worth more money. The creditor was greatly undersecured at bankruptcy, and apparently was also undersecured during the entire 90-day period. The trustee correctly reasoned that the payments enabled GMAC to receive more of the unsecured portion of the loan. Section 547(b)(5) does not require the trustee or court to speculate on the creditor's activity had the preferential payment not been made. For a case decided correctly on facts identical to Bullen, see In re McCormick, 5 Bankr. 726 (Bankr. N.D. Ohio 1980).

The clean, mechanical § 547(b)(5) test authorizes no such speculation. It demands a simple comparison: has the creditor received more than what he would have received in liquidation had the transfer not been made? The principle of equality in distribution gives no greater rights to parties who have received preferences and continued doing business with the debtor in the ordinary fashion as compared to those who have not received preferences. All have not anticipated the debtor's bankruptcy, and those who receive payments should not be better off. Those cases in which a creditor is permitted “preferred” treatment are contained in § 547(c).
\end{footnotesize}
section 60 cases, the transfers were truly “worthy,” and the end result could be justified on independent policy grounds. In fact, many of those transfers are now specifically protected under section 547(c). Unfortunately, when these cases were decided, section 60 did not provide a direct route to achieve this protection.

Cases like Julian, however, are far less justifiable. This kind of ad hoc exception undermines the equality of distribution principle even more central to section 547 than to old section 60. The problems with section 60(c) have been corrected in section 547(c)(4). This accomplished, the diminution of the estate element and its case law corollaries are at best unnecessary. At worst, continued resort to this requirement and its progeny will lead to cases that distort the new preference scheme.

Such a distortion occurred in the case of In re Fulghum Construction Co. The creditors were major shareholders of the corporation and had extensive knowledge of its dire financial condition. They loaned additional money to the corporation during the critical period, which enabled the corporation to complete certain jobs. The payments from those jobs were subsequently transferred to these creditors in payment. The trustee sought to avoid these clearly preferential transfers under

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187. Each of the judicially created exceptions to § 60 has some independent policy basis. For example, many of the “current expense” cases involving payments to trade creditors, employees or utilities, supra note 50, were prompted by a need to protect those transfers. These services are essential to continuation of the business and therefore preserve the “going-concern” value of the enterprise. See supra text accompanying notes 43-45. The original case law net result rule as applied to running accounts creditors may be similarly justified. Those rules designed to protect the floating lien secured creditor are also probably based on a judicial determination that these secured credit arrangements should be protected despite the absence of an explicit basis in the statute. See supra text accompanying notes 81-95.

188. See supra text accompanying notes 43-45.

189. 4 BANKR. CT. DEc. (CRR), at 1297-99.

190. For a discussion of the problems with § 60(c), see supra text accompanying notes 181-83. See also infra text accompanying notes 284-89.

191. Equality of distribution is the cornerstone of § 547. See supra note 43. Factors such as creditor knowledge, intent to gain advantage, or participation in the race of diligence are no longer relevant. Litigation over “bad” preference behavior has been reduced for the sake of efficiency. One court, although sympathetic to the creditor who received payment in good faith, correctly and vigorously applied the § 547 test. In re Keeling, 11 Bankr. 351, 362 (Bankr. D. Minn. 1981). While the court expressed some doubt about the justice of the mandated result, its doubt was misplaced. Section 547 does not punish creditors who have received payment. It merely places them in the same position as others who have not.

section 547. The creditors successfully argued that there was no preference under the case law net result rule. The bankruptcy court accepted the creditor's argument that diminution of the estate remained an element of a preference under section 547, and on appeal the district court agreed. Moreover, both courts concluded that the corollary case law net result rule was also reincorporated into new section 547(b) in the absence of legislative history to the contrary. Although such legislative history did exist, it was not mentioned in either opinion. Like the earlier Julian case, Fulghum applied a rule derived from section 60(a) case law even though an explicit exception designed to provide credit against preferential transfers failed to go far enough to satisfy these creditors. Fulghum provides even less justification for applying the case law net result rule than did Julian. Fulghum involved insider creditors who, as major shareholders, were trying to preserve their investments. Both Fulghum opinions went to great lengths to extend the rule to cases where the creditor had knowledge of the debtor's insolvency. Finally, both courts took for granted the validity of a section 60 concept in the new section 547 structure.

In Fulghum, the bankruptcy court and the district court both reasoned that the estate was not diminished because the additional loans enabled the corporation to complete the jobs and obtain payment. Of

193. Id. at 643, 647; 14 Bankr. at 304.
194. Id. at 647; 14 Bankr. at 304.
195. Both the Gilmore Committee Report and the Commission Report recommended subsequent advance exceptions derived from old § 60(c). GILMORE COMMITTEE REPORT, supra note 9, § 60a(4)(II); Commission Bill § 4-607(c)(2). Both the Gilmore Committee Report and Commission Report recognized the existence of the case law net result rule and indicated that the new subsection was replacing those cases. GILMORE COMMITTEE REPORT, supra note 9, at 215. The clearest statement was contained in the Commission Report:

The Commission's recommendation does not, however, go as far as the "net result rule" established by some early cases. A true "net result" rule would total all payments and all advances and offset the one against the other. This is not allowed under the Commission's recommendation, since the advance to be offset must be subsequent to the preference.

COMMISSION REPORT (pt. 1), supra note 8, at 210-11.

Although § 547(c)(4) was subsequently redrafted to deal with the "remaining unpaid" and security problems, the requirement that the advance occur subsequent remained unchanged. There was no indication of any attempt to resurrect the case law net result rule.

The House and Senate Reports, not surprisingly, make no mention of the case law net result rule. They do, however, recognize that the § 547(c)(4) formula covers cases in which "the creditor and the debtor have more than one exchange during the 90-day period. . . ." HOUSE REPORT, supra note 12, at 374; SENATE REPORT, supra note 12, at 88.
196. 7 Bankr. at 647; 14 Bankr. at 305.
course, every creditor of the bankrupt, including suppliers, employees, and other unsecured lenders could make the same argument. The sole difference between these shareholders and other creditors was that the shareholders received payment. This is precisely the inequity section 547 was designed to prevent. The shareholders had no security interest in these payments. The other unsecured creditors are entitled to share at least equally with these shareholder creditors. Moreover, some unsecured creditors have been designated for priority over these shareholder creditors.\textsuperscript{197}

The \textit{Fulghum} courts were apparently dissatisfied with the congressional limits on the credit set-off expressly available against preferential transfers. Under section 547(c)(4), as under section 60(c),\textsuperscript{198} the creditor is entitled to set off against specific preferential transfers \textit{subsequent} qualifying new value.\textsuperscript{199} In \textit{Fulghum}, only some of the creditor's advances were subsequent to the preferential payments.\textsuperscript{200} The trustee unsuccessfully argued that the creditors were only entitled to the exclusive and more limited relief of section 547(c)(4). He argued that this exception only applied after all the elements of section 547 had been proved, and that no case law net result rule should be injected into

\begin{itemize}
\item \textsuperscript{197} Some unsecured creditors such as employees, consumer customers, and taxing governmental units would have limited priorities under \textsection 507 over general unsecured creditors like the shareholders in \textit{Fulghum}. \textsuperscript{198} See, e.g., Farmers Bank v. Julian, 383 F.2d 314 (8th Cir.), \textit{cert denied}, 389 U.S. 1021 (1967). \textsuperscript{199} See \textit{supra} text accompanying notes 181-83; \textit{infra} text accompanying notes 284-95. \textsuperscript{200} Because the defendants, Ranier & Associates, were "insiders" as defined in \textsection 101(26), the relevant period was the one year prior to the filing of a petition on January 5, 1980. The balance sheet reflecting this one year period was made available to the authors by the trustee, Robert H. Waldschmidt of Cosner, Waldschmidt & Cracker, Nashville, Tennessee. During this period, approximately 70 transactions took place between Fulghum Construction and Ranier & Associates. Some of these transactions involved rental payments for certain construction equipment which was sold by Fulghum to Ranier in a disputed sale and leaseback arrangement. This arrangement was upheld by both the bankruptcy and district courts. 14 Bankr. at 297-300. These rental payments, however, were also preferential and at least some of them were not made within the 45 days set out in \textsection 547(c)(2). Unless Ranier & Associates met their burden under \textsection 547(c)(2), all of these payments would be recoverable. It is not clear whether the trustee attempted to recover all these as preferences, but he did try to recover those paid after July 27, 1979.

Although these transactions are difficult to reconstruct, a few facts are clear. Most important, Fulghum made a preferential payment of $300,000 to Ranier & Associates on November 30, 1979. No advances were made after this date and this entire amount was recoverable. Between July 27, 1979, when Ranier received a $100,000 preference, and November 11, the date of the last advance, Ranier received preferences totalling $931,400. Ranier made advances qualifying as \textsection 547(c)(4) credit totalling $837,000. The trustee should therefore recover an additional $94,000 in preferences.

\end{itemize}

http://openscholarship.wustl.edu/law_lawreview/vol61/iss1/1
section 547(b). The *Fulghum* courts rejected these arguments finding that two net result rules, one in section 547(b)(5) and a narrower one in section 547(c)(4), must exist side by side in the preference section.

The section 547(c)(4) distinction between prior advances and advances made after preferential transfers is not only clear, it is sound. A person who receives a preferential payment and then enriches the estate with new value has “redeemed” himself. A person who advances credit before receiving a preference is no different than any other creditor who has given money, goods, or services to the debtor with one exception. He has been paid! Furthermore, a creditor who makes advances during the critical pre-petition period and subsequently receives a preference is no different than his counterpart who advances money just before the critical period and subsequently receives a preference. Another recent case has denied an arguably more deserving good faith creditor the benefit of the case law net result rule because it undermines the legislative judgment behind section 547(c)(4). Indeed, the *Fulghum* result undermines the selective legislative judgment behind all of the section 547(c) exceptions.

A broad “injection” of the case law net result rule into section 547(b) would make section 547(c) largely superfluous. As long as a creditor gave as much or more credit than the payment received, he could argue that the estate was not diminished. What need for section 547(c)(1), protecting substantially contemporaneous exchanges? If the value given and the debtor’s transfer have equal value, the net result rule could protect the transfer even if it is not substantially contemporaneous. Why have section 547(c)(2) protecting ordinary course payments?

201. 7 Bankr. at 647; 14 Bankr. at 303.
202. Id.; 14 Bankr. at 304.
203. In defense of a common law net result rule at least one commentator has taken the position that pre-preference credit during the critical period should be treated the same as post-preference credit during the period. See Taylor, *supra* note 185, at 921. However, the creditor who extends unsecured credit before being preferred is certainly different from the creditor who, subsequent to a preference, redeems the transfer with an infusion of new credit. The pre-preference credit extension was not in any sense induced by the particular preferential payment in question. Only the arbitrary time frame of the critical period makes the pre-preference advance within the period distinguishable from all those extensions of credit just before the beginning of the critical period.
204. *In re* Rustia, 20 Bankr. 131 (Bankr. S.D.N.Y. 1982). *See also In re* Thomas W. Garland, Inc., 19 Bankr. 920 (Bankr. E.D. Mo. 1982). All utility bills that are timely paid, as they were in *Garland*, will be protected if Congress acts to expand the § 547(c)(2) time frame. *See supra* note 15. The drafters of § 547 clearly intended to protect these payments and this change would be warranted. *See supra* text accompanying notes 47-65.
made within forty-five days of the debt? As long as the payments were for equal value received, the estate would not be diminished even if the payments came after forty-five days or outside the ordinary course. Would section 547(c)(3) be necessary because an enabling loan by definition enables the debtor to purchase goods which enrich the estate? Why have section 547(c)(4) give a set-off for subsequent advances? After all, the case law net result rule provides a set-off for subsequent and prior advances.205

Although no court would give such broad application to the rule to reach this absurd result, selective application of the rule is no more justifiable. It allows some creditors to receive better treatment than other creditors who have not been paid, even though Congress has not provided them with exceptional treatment under section 547(c).206

It should be noted that section 547(c) provides considerable protection for insider creditors such as those in Fulghum. They were, of course, entitled to the more limited protection of section 547(c)(4). Moreover, had they taken and perfected a security interest in the accounts, they would have been entitled to the considerable protection of section 547(c)(5).207

The case law net result rule began under section 60 to protect the running accounts creditor against a technical injustice. Its continuing validity under section 60, even in the running accounts cases, was doubtful. Its application to creditors such as the Fulghum shareholders seems most inappropriate even under old section 60, and certainly it has no place in the new preference scheme.

205. 7 Bankr. at 646. The application of the case law net result rule in the face of the § 547(c) exceptions recalls to mind the story of the farmer who cut two holes in his barn: one for his big dog, one for his little dog.

206. See supra note 43.

207. If the creditor had taken a security interest in the accounts, he would have been entitled to all bankruptcy accounts, except to the extent that the gap, if any, between collateral and indebtedness was narrowed during the period described in § 547(c)(5). See infra text accompanying notes 296-308. Because the indebtedness was apparently small at the beginning of the relevant period, § 547(c)(5) might have protected almost all of these transfers. The creditors, however, neglected to obtain a security agreement. They have no one but themselves to blame for their less favorable treatment as unsecured creditors. Nor should the court utilize a contrived device such as the case law net result rule to protect these creditors from their own mistakes. In fact, if the shareholders had taken a security interest and perfected it, other creditors might have been given helpful notice of the state of the debtor's financial affairs.
C. Some Problems in the Context of Commercial Financing: Suggested Solutions

1. Acquiring Collateral: The Circularity Problems in Section 547(b)(5)

a. In General

In an after-acquired property financing arrangement, both transfers of security and payments typically occur during the critical pre-petition period. As already noted, in applying the "receives more" test of section 547(b)(5), the trustee will measure the effects of these transfers on the creditor's recovery in the actual liquidation.\(^{208}\) If only one type of pre-petition transfer is involved, and if none of these transfers are protected by the exceptions in section 547(c), the mechanics of section 547(b)(5) are neatly applied. If only section 547(b) need be considered, payments on the antecedent debt during the critical period will be avoidable preferences unless the creditor was truly fully secured or unless he would have received the same payment in liquidation.\(^{209}\) Collateral transfers during the critical period will be avoidable preferences unless they are superfluous.\(^{210}\)

b. Payments and Collateral Acquisitions

When both collateral transfers and payments occur during the critical period, the application of the section 547(b)(5) test appears to be circular. When payments are challenged, the trustee must prove that the creditor is not fully secured. In order to prove this, he may have to determine the extent to which collateral held is the product of avoidable transfers. When these collateral transfers are being challenged, the trustee must establish which transfers are preferences and which are merely superfluous. To make this determination, the trustee must apparently decide the extent to which payments are avoidable.\(^{211}\) Where does the trustee start? At first blush, the trustee cannot start with either collateral transfers or payments without making circular assumptions.

\(^{208}\) See supra text accompanying notes 136-39.
\(^{209}\) See supra text accompanying notes 132-34 & 146-49.
\(^{210}\) See supra text accompanying notes 140-41.
\(^{211}\) The trustee would need to make this determination in order to calculate the size of the creditor's claim against which the creditor seeks to reach collateral. If payments are avoided, the size of the claim will of course be increased.
Assumptions are appropriate, but they need not be circular in order to faithfully apply section 547(b)(5). Consider the following illustration:

CASE 7. The creditor (Smith) entered the ninety-day period with a security interest in the debtor's (Jones) machines, now owned or after-acquired. At that time, Jones owned machines A and B, worth $50,000 each. Jones owed Smith $150,000. On January 10, Jones sold machine A with authorization but squandered the proceeds. On January 30, in an unrelated transaction, Jones acquired two new machines, C and D, worth $50,000 each. On February 1, Jones paid Smith $50,000. On February 15, he acquired one more machine, E, also worth $50,000. On March 1, Jones paid Smith another $50,000. On April 1, the bankruptcy petition was filed.

In Case 7, the trustee will challenge both the payments and the collateral transfers. The circularity problem is avoided by starting with one basic assumption: under the section 547(b)(5) test, the creditor is only entitled to discrete items of collateral or the proceeds of previously held collateral on hand both at the beginning of the critical period and also on hand in its original form or as proceeds on the date of the petition. All items acquired during the critical period either improve the creditor's position under the section 547(b)(5) test or are in excess of the creditor's claim and are therefore superfluous.212 213

In Case 7, machine B is the only machine which is neither vulnerable under section 547(b)(5) nor superfluous. If Smith finds it necessary to resort to his security in any other machine to satisfy his claim, then the transfer of that security "enables him to receive more." If Smith does not find it necessary, he can make no claim to the machine. While the trustee will not be able to place the collateral transfers in one of these two categories until he determines the extent to which payments can be recovered, he can assume that the additional collateral must be in one of these categories, and therefore remains "unavailable" to the creditor.213 Since it is clear that no section 547(c) exceptions apply in this

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213. In Case 7, if both $50,000 payments are preferential and therefore avoided, the creditor's adjusted claim becomes $150,000. Since this is the maximum adjusted claim, at most the creditor could recover $150,000 in collateral. Machine E, therefore, clearly falls in the category of superfluous collateral. Machines C and D are preferential if the trustee recovers both payments. With the obligation adjusted back to $150,000, the acquisition of machines C and D enables him to "receive more," that is, to become fully secured as compared to unsecured for $100,000. If only one payment is recoverable, only the interest in machine C is a preference, but machine D becomes superfluous, since the claim would only be $100,000. Finally, if no payments are avoidable, only machine B would be necessary to satisfy the outstanding $50,000 claim; the other machines,
illustration, the trustee can now determine to what extent collateral is “available” to the creditor because the transfer is neither avoidable nor superfluous. Only the creditor’s claim to machine B survives this application of section 547(b).

Since the trustee can determine the extent to which collateral is properly “available” to the creditor, he can also determine if payments were made to a truly fully secured creditor. Because the creditor can claim only machine B, both of the $50,000 payments made during the critical period are preferential. Without these payments the creditor’s claim in liquidation would be $150,000 secured by $50,000 in collateral. As a result, he would get the collateral and have an unsecured claim for $100,000. With these payments, the creditor holds $100,000 and claims only $50,000 secured by $50,000 of unavoidable collateral. With the payments there would be no unsecured claim. Unless the estate is sufficient to completely satisfy all unsecured claims, a virtual impossibility in bankruptcy, the payments clearly enable the creditor to “receive more.”

Once the trustee has established that these payments meet the section 547(b)(5) test, he can easily determine in which category of “unavailability” the collateral transfers fall. In Case 7, the creditor now has a $150,000 claim. If Smith is permitted to reach any machine, C, D, or E, the transfer will enable him to “receive more.”

The circularity problem created by the relationship between payments and transfers of collateral, common to after-acquired property financing, is therefore overcome by resort to a single, valid assumption. In applying section 547(b)(5), the creditor is only entitled to collateral or its proceeds held at the beginning of the critical period and still held on the date of the petition in its original or proceeds form.

c. The Section 547(b)(5) Comparison and the Section 547(c) Exceptions

The relationship between sections 547(b)(5) and 547(c) suggests a
second potential circularity problem. If a collateral transfer is unavoidable because one of the section 547(c) exceptions applies, related payments might seem safe because of the resulting improvement in the creditor's secured position. Following this reasoning, section 547(b)(5) could be read to include a complete section 547(c) analysis as part of the comparison of liquidation positions required by the "receives more" test. This approach ignores the purpose of section 547(b) in the preference scheme and creates a number of serious problems easily avoided by applying the section 547(b)(5) liquidation comparison without an "advance" application of section 547(c). Consider the following illustration:

CASE 8. The creditor (Smith) entered the ninety-day period on January 1 with a security interest in two of the debtor's (Jones) machines, A and B. Each machine was worth $50,000. At that time, Jones owed Smith $100,000. On January 10, Jones sold machine A with Smith's authorization, granted in return for a security interest in another of Jones's machines, C. Unfortunately, Jones was tardy in executing the new security agreement and did not sign the agreement until January 19. Smith filed a financing statement on the same day. On February 1, Jones paid Smith $50,000. No other relevant events occurred until April 1, when a bankruptcy petition was filed.

Under section 547(e)(2), the transfer of the interest in machine C cannot occur before January 19, the date the security interest is effective between the parties. This is a transfer of security for an antecedent debt. It is clear that section 547(c)(1) eventually protects the transfer of the interest in machine C. The authorization to sell the collateral, which is a release of a security interest, fits the definition of

215. Under U.C.C. § 9-203(1)(a), a security interest is not enforceable and does not attach until the "debtor has signed a security agreement which contains a description of the collateral." This occurred on January 19. The phrase in § 547(e) "at the time such transfer takes effect" is not defined in the Code and apparently refers to effectiveness under applicable state or federal law. For an Article 9 security interest, this occurs at attachment. Subsection (e) might therefore seem unnecessary, since attachment can never occur until the debtor has also received value and acquired rights in the collateral. Subsection (e)(3) was added to specifically overrule cases such as DuBay v. Williams, 417 F.2d 1277 (9th Cir. 1969), which dated the transfer back to the time of filing. This subsection effectively prevents courts from attempting to make a transfer effective before the collateral is acquired by reading DuBay theory into the state law. For example, a court in a nonbankruptcy case has dated the perfection of the security interest in after-acquired accounts as the date of the original filing. Rocky Mountain Ass'n of Credit Management v. Hessler Mfg. Co., 553 P.2d 840, 842-43 (Colo. Ct. App. 1976).

new value in section 547(a)(2). The parties intended a contemporaneous exchange and the exchange was substantially contemporaneous. If section 547(c) is applied as a part of the section 547(b)(5) test, the transfer of collateral would be protected at liquidation even though it enabled the creditor to "receive more." If the collateral is already viewed as protected when the subsection (b)(5) test is applied to the payment, then it appears that the payment does not enable him to "receive more." The payment seems to have been secured by the additional collateral. The advance application of subsection (c) creates a misleading impression that the payment was to a fully secured creditor and also not preferential. If the payment is not preferential, Smith's claim is only $50,000 and his security interest in machine C is superfluous. When application of section 547(c)(1) is made a necessary predicate to the section 547(b)(5) calculation, the real intent of section 547(c)(1) is warped. Section 547(c)(1) is designed to protect "substantially contemporaneous" transfers. The effect of the advanced application of subsection (c) is to protect a payment which is not even arguably substantially contemporaneous. The substantially contemporaneous transfer—the transfer of the interest in the substitute machine—has been rendered superfluous by protecting the payment under subsection (b)(5).

On the other hand, if the section 547(b)(5) test is applied without first considering section 547(c), proper characterization of both the transfer of collateral and the payment is easy. If the trustee utilizes the basic assumption used to solve the first circularity problem, the transfer of machine C is either preferential under section 547(b) or superfluous. In either case, before section 547(c) is applied, Smith can only claim machine B. With the payment, Smith has $50,000 in cash and a $50,000 claim secured by $50,000 in collateral. Without the transfer,
but before section 547(c) is applied, Smith's liquidation position would be a $100,000 claim secured by $50,000 in collateral. The payment of $50,000 is therefore preferential because it enables Smith to "receive more" under the section 547(b)(5) test. At this point, it is clear that the collateral transfer is not superfluous since Smith's claim becomes $100,000 after section 547(b) is applied to the payment. The collateral transfer, therefore, is preferential under section 547(b). This is the appropriate time for Smith to prove that section 547(c)(1) protects the tardy substitution of the security interest in machine C. If Smith carries his burden of proof under section 547(c)(1), he will be left with a $100,000 claim and $100,000 in collateral.\footnote{219}

Why is it important to the new preference scheme that the trustee be able to avoid a payment, only to validate an equivalent transfer of security? Often there may be no reason, and the trustee has nothing to gain by seeking avoidance of the payment.\footnote{220} If, however, there is question of value, the parties will receive the asset with which they are best suited to deal. Essentially, the risk that the value of collateral is less than the claim falls on the secured party, not the estate.

There are more compelling reasons to follow this approach, reasons that go to the heart of the new integration scheme. First, the language of section 547 indicates that transfers meeting all the requirements of section 547(b) may be avoided "[e]xcept as provided in section 547(c)." This clearly seems to require application of all the elements of section 547(b) before the exceptions in section 547(c) are relevant. The legislative history supports this view.\footnote{221} In addition, this approach is consis-

\footnote{219. The creditor has the burden of proving that § 547(c) exceptions protect a transfer. See \textit{supra} note 76.}

\footnote{220. If the § 547(c)(1) exception applies, the trustee could avoid the payment, but not the collateral transfer. If he does not avoid the payment, the estate will recapture the collateral because the creditor has no claim to it. In either case, the estate recaptures the identical amount of property. If the trustee's compensation is tied to the amount of property brought into the estate, there is no incentive to recapture preferences which result in the estate losing collateral. Therefore, the trustee may decide to forego recovery.}

\footnote{221. This structure, a broad general definition of avoidable preferences followed by exceptions to the trustee's avoidance power, was present in the Gilmore Committee redraft of § 60, the Commission Bill, Judges' Bill and NBC Bankruptcy Act of 1975. Proponents recognized that transfers within the critical period would fit the general definition of a preference, but these preferences could be protected by exceptions. \textit{See}, e.g., \textit{1976 House Hearings, supra} note 43, at 1859 (statement of Mr. Forman on behalf of National Bankruptcy Conference). The \textit{NBC Bankruptcy Act of 1975, supra} note 60, amended the Commission Bill by adding an introduction to the exceptions subsection which stated that "notwithstanding subsection (a), the trustee may not avoid any of the following transfers. . . ." § 4-607(b), at 362. The NBC Bankruptcy Act made this amendment to
tent with the proper allocation of the burden of proof. In Case 8, the trustee met his burden under section 547(b) and initially could avoid both the collateral transfer and payment. To protect the additional collateral, Smith then was forced to prove all the elements of section 547(c)(1), most importantly, that a contemporaneous exchange was intended. If application of the section 547(c) exceptions were essential to the comparison required by section 547(b)(5), the trustee would be in an anomalous position. Because the trustee bears the burden of proof with respect to the elements of a preference in section 547(b), he would have to prove that the section 547(c) exceptions did not apply.\footnote{222}

Another compelling reason for applying section 547(b)(5) without resort to section 547(c) is practical necessity. When after-acquired property financing is involved, numerous payments and collateral transfers may occur during the critical pre-petition period. The avoidability of payments may depend on whether the creditor is truly fully secured or whether his apparently fully secured position is preference-built. At best, the incorporation of the section 547(c) exceptions into section 547(b)(5) makes the “receives more” test unnecessarily complex. Moreover, certain section 547(c) exceptions, particularly subsections (c)(4) and (c)(5), require initial determinations of the avoidability of payments or collateral transfers.\footnote{223}

\section*{2. Acquiring New Collateral: The Substitution Problem}

An analysis of the “true” collateral substitution demonstrates how radically different the new definition in section 547(b) is from the old one in section 60. A “true” substitution occurs when a creditor releases collateral in a simultaneous exchange for a security interest in new collateral. Substitutions which are slightly tardy are certainly covered by

\footnote{clarify that “each of the various exceptions to subsection (a) . . . is available as a defense in any given case”. Id. at 363 (emphasis added). See \textit{Commission Report} (pt. 2), \textit{supra} note 8, at 171 n.14; \textit{Gilmore Committee Report}, \textit{supra} note 9, at 214. \textit{See also Kronman, supra} note 11, at 140.

Although Congress did not choose to adopt this National Bankruptcy Conference language, it clearly intended to adopt the same approach suggested by these earlier drafts. The House and Senate Reports refer to \$ 547(b) as “the operative provision of the section.” \textit{House Report}, \textit{supra} note 12, at 372; \textit{Senate Report}, \textit{supra} note 12, at 87. The explanation of \$ 547(c) refers to the provisions as “exceptions to the trustee’s avoiding power” and as protection from avoidance. \textit{House Report}, \textit{supra} note 12, at 373; \textit{Senate Report}, \textit{supra} note 12, at 88.

\footnote{222. \textit{See supra} note 76.}

\footnote{223. For a discussion of the complications that arise in integrating the \$ 547(c)(4) and \$ 547(c)(5) exceptions, see \textit{infra} text accompanying notes 320-46.}
the section 547(c)(1) exception. 224 Under section 60, a substantially contemporaneous substitution was sometimes treated in the same manner as a “true” substitution, which was not preferential to the extent the estate was not diminished. 225 Under section 547(b), these substantially contemporaneous exchanges are preferential, but will be protected under section 547(c)(1) if the creditor can prove that a contemporaneous exchange was intended.

Similarly, acquisitions of new inventory and receivables are no longer protected by a warped interpretation of the “greater percentage” concept. Under section 60, a “relaxed substitution” theory appeared in cases involving floating liens. This theory ignored the timing of the sales and “replacement” acquisitions. To the extent that there was no improvement of position, these transfers of replacement collateral did not “diminish the estate” and were held not to be preferential. This case law has been displaced. All collateral acquisitions are preferences under section 547(b), but inventory and receivable acquisitions are protected to the extent provided in section 547(c)(5). 226

How then is the “true” substitution of collateral dealt with under the new integration? Is this “true” substitution protected by finding the transfer to be outside the section 547(b) definition? Or is this substitution in fact preferential, but also protected by an express exception in section 547(c)? Consider the following illustration:

CASE 9. The creditor (S) is owed $25,000 secured by a security interest in the debtor’s (D) semi-trailer worth $22,000. D wishes to sell this collateral to raise cash. D has another semi-trailer which is unencumbered and worth $22,500. S releases his security interest in the first semi-trailer in exchange for a security interest in the second. The exchange is simultaneous. Two months later a petition is filed.

A substitution of collateral was not a preference under section 60(a) to the extent there was no “diminution of the estate.” 227 Congress, in radically redesigning the preference scheme, has changed the manner in which this transaction is analyzed. First, the transfer of the security interest in the substitute collateral satisfies all the elements of a section 547(b) preference. This would be true even if the new collateral were worth the same or less than the old, instead of more, which is the situa-

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224. See supra text accompanying notes 215-19 (discussion of Case 8, involving substitution).
225. 2 G. Gilmore, supra note 6, at 1315.
227. 3 COLLIER ON BANKRUPTCY ¶ 60.21 (14th ed. 1976); 2 G. Gilmore, supra note 6, at 1315.
tion in Case 9. Although the release and the transfer are conditioned on one another, section 547(b) addresses only the transfer to the creditor, not the net effect of the entire exchange. The transfer is clearly “to or for the benefit of the creditor.” The antecedent debt requirement is met despite the fact that new value, in the form of a release of collateral, is given. In Case 9, the newly transferred security interest still secures the antecedent debt of $25,000, which would be true under most commercial security arrangements.\textsuperscript{228} Since the transfer was made during the critical period while the debtor was presumptively insolvent, a section 547(b) preference will exist if the subsection (b)(5) test is satisfied. The radical simplicity of the section 547(b)(5) test is most apparent here. Net “diminution of the estate” is not an element under section 547(b)(5). The comparison required by section 547(b)(5) is not a comparison of the creditor’s positions with each of the two semi-trailers. Rather, the section 547(b)(5) test requires a comparison of the creditor’s position with the security interest in the second semi-trailer and his position if “the transfer had not been made.” The section 547(b)(5) test does not require or permit a comparison with his position if the entire exchange had not been made. Without the transfer, he would have no security; therefore the transfer enables him to “receive more.” As a result of the elimination of the “diminution of the estate” element from the definition in section 547(b), the transfer of the new security is a preference whether its value is more, less, or equal to the old security.

Of course, application of the clean, mechanical, and inclusive definition of a preference in section 547(b) is merely the first step. Some transfers formerly protected by the “diminution of the estate” requirement are, to a more limited extent, protected under section 547(c). In fact, each of the section 547(c) exceptions is designed to assure relative equivalency between the transfer and the benefit to the estate. Section 547(c)(1) provides one of these exceptions and it works perfectly in Case 9 to protect the transfer of the security interest in the second semi-trailer. The creditor, $S$, has given new value, the release of collateral, in exchange for the transfer. The exchange was intended to be contemporaneous and is in fact substantially contemporaneous.

Section 547 (c)(1) protection is not identical to the protection formerly given by the “diminution of the estate” requirement. For exam-

\textsuperscript{228} 2 G. Gilmore, \textit{supra} note 6, § 45.5, at 1309.
ple, creditor $S$ in Case 9 fares better under section 547(c)(1) than he would have fared under section 60. While section 60 case law protected the substitution only to the extent that there was no "diminution of the estate," new section 547(c)(1) contains no explicit requirement of equivalent value. Reasonable equivalency of value, however, is assured by section 548, which permits trustee avoidance of fraudulent transfers.\textsuperscript{229} In Case 9, $S$ would be entitled to the entire value of the new security, assuming that the two semi-trailers have reasonably equivalent values and that there was no actual intent to defraud other creditors.

An analysis of the drafting history reveals that the section 547(c)(1) exception applies to "true" as well as slightly tardy substitutions.\textsuperscript{230} The Gilmore Committee proposal contained an explicit exception for both simultaneous and substantially contemporaneous substitutions.\textsuperscript{231} This specific exception was abandoned as unnecessary when the forerunner to the section 547(c)(1) exception was developed.\textsuperscript{232} Moreover, it makes little sense to exclude true substitutions from the coverage of

\textsuperscript{229} The Bankruptcy Code, § 548(a)(2), allows the trustee to avoid a transfer to a creditor within a year of bankruptcy if the debtor "received less than a reasonably equivalent value in exchange for such transfer . . . and was insolvent on the date that such transfer was made." 11 U.S.C. § 548(a)(2) (Supp. V 1981).

\textsuperscript{230} See supra text accompanying note 12.

\textsuperscript{231} *Gilmore Committee Report*, *supra* note 9, at 210, 215.

\textsuperscript{232} The Commission eliminated the relaxed substitution exception contained in the Gilmore Committee Report when it added the grace period to the exclusions from the antecedent debt definition. The Commission, perhaps misled by the literature, apparently assumed that true substitutions of collateral were not for antecedent debt and therefore not preferential under § 60. \textit{See, e.g.,} 3 *Collier On Bankruptcy* § 60.20 (14th ed. 1976). Therefore, the grace period was believed necessary to protect only tardy substitutions. Under certain pre-Code financing arrangements secured by shifting collateral designed to comply with the requirements of Benedict v. Ratner, 268 U.S. 353 (1925), the creditor received the proceeds of the released collateral. This extinguished a portion of the debt. The creditor then "released" the money and received the new collateral in exchange. Under this type of arrangement, the transfer was not "for or on account of antecedent debt," but rather security for a new loan. Under modern financing arrangements in shifting collateral, this is not the case. The Uniform Commercial Code permits arrangements in which the debtor has complete control over the proceeds of collateral. \textit{See} U.C.C. § 9-205(1); \textit{id.} comment 1. Although good financing practice would include some policing of the collateral and its proceeds, financing arrangements which contemplate complete creditor control over the proceeds are extremely rare. Therefore, in most cases substitutions of collateral were transfers "for or on account of an antecedent debt." Nevertheless, substitutions were protected to the extent that there was no "diminution of the estate." \textit{See supra} text accompanying note 225.

The Commission approach was abandoned, and the protections intended in the Gilmore Report and in the § 4-607 grace period were drafted into § 547(c)(1). Because the "true" substitution clearly fits the § 547(b) preference definition and the § 547(c)(1) language seems to protect it, it is likely that the exception was intended to do so.
section 547(c)(1), because that would leave true substitutions with less protection than substitutions which were substantially contemporaneous.233

More importantly, by protecting true substitutions under section 547(c)(1), a court accomplishes a number of things consistent with the preference scheme. First, the definitional integrity and potential efficiency of section 547(b) are preserved.234 The role of protecting transfers is placed in section 547(c) and this protection is limited in accord with the carefully designed qualifications of section 547(c). Second, the burdens of proof in substitution cases will be correctly allocated between trustee and creditor. The trustee meets his burden by proving that the creditor has transferred the interest within the ninety-day period on account of money loaned before the transfer. In order to protect the transfer, the creditor must prove, as he should, that the section 547(c)(1) requirements are met. The creditor must prove that an exchange, a release for a substitution, was intended.235 It should be relatively easy for the creditor to prove this unless a substitution was not intended and what actually occurred was merely a transfer of additional security along with a coincidental but contemporaneous loss.236

233. If "true" substitutions are protected under the phantom "diminution of the estate" element, any excess value is preferential and avoidable. Under § 547(c)(1), this is not the case. Unless the substitution is fraudulent, the trustee cannot avoid it. A substitution would be fraudulent only if there were not a reasonable equivalency of value or if there were an actual intent to defraud other creditors. 11 U.S.C. § 548(a) (Supp. V 1981).

234. Injecting either the net result rule or a "diminution of the estate" requirement into § 547(b) in order to protect these substitutions might encourage further applications of these protective case law concepts. Some of these potential applications may be damaging to the structure of the entire preference scheme. For a discussion of the Fulghum case, an example of the danger of this approach, see supra text accompanying notes 192-207. If the protection of § 547(c) is treated as the sole source of exceptions, the protection will more likely be restricted to the limited cases chosen by Congress. Once the exclusive role of subsection (c) is clearly reinforced in the courts, creditor resistance to recaptures which are clearly vulnerable should diminish. At the same time, trustee challenges to transfers clearly within the protection of subsection (c) should also decline. Before the new structure has had a chance to work, critics have challenged it as being unfair and inefficient. Although a legislative expansion of the protection for ordinary course transfers in subsection (c)(2) may be appropriate, the fundamental change in § 547(b) proposed in S. 2000 is an overreaction. See supra note 15.

235. The relatively insignificant "windfall" to the creditor, made possible by the absence of an absolute equivalency requirement in § 547(c)(1), is more than offset by the advantages to the trustee and the estate that flow from this approach. The elimination of the "diminution of the estate" requirement and the shift to the creditor of the burden of proving the applicability of the exception will result in the trustee recovering far more property than would otherwise be the case.

236. A creditor authorizing the sale of collateral in exchange for a new security interest should document the exchange. This can easily be done if a new security agreement is executed. If the
V. APPLYING THE SECTION 547(c) EXCEPTIONS TO AFTER-AcQUIRED PROPERTY FINANCING

A. Preface

In section 547(c) Congress has grouped some, but not all, of the protective concepts formerly inseparable from the old Act's definition of a preference. The simplification of section 547(b) is in large part the result of a transfer of protective functions from the definition to an explicit list. A more detailed consideration of section 547(c) as it relates to commercial financing is necessary for a number of reasons. First, the burden of proof under section 547(c) passes to the financing creditor. If the trustee meets the new relaxed burden of proving the uncluttered elements of section 547(b), the creditor must prove all the elements of one of the section 547(c) exceptions in order to protect the transfer. Second, old Act case law should be relied on only with caution when applying the section 547(c) exceptions. Although many of the basic protective concepts of section 547(c) are similar to those developed under section 60, the section 547(c) exceptions are not identical. Some changes have been made and some exceptions are far more carefully and narrowly directed than case law constructs of section 60. Finally, the statute provides little or no guidance on the integration of these newly drawn exceptions. An understanding of how each exception operates in isolation is necessary to any intelligent theory of integration. A theory of integration is critical, especially when after-acquired property financing is involved, because typical financing arrangements will bring into play more than one exception. The calculations required for some of these exceptions depend both upon assumptions about the impact of section 547(b) and assumptions about the other section 547(c) exceptions.

To begin, it may be helpful to review the individual exceptions and resolve some problems about their meaning and scope. Ambiguity sometimes exists in the language of the statute and the most visible legislative history does not resolve the difficulty. The statute must be construed consistently with the basic preference scheme and the com-

debtor intends to purchase new collateral which will be picked up by the creditor under an after-acquired property clause, however, there is potential danger. Unless the creditor insists on some documentation of the intended exchange, he might have difficulty meeting his burden of proof under § 547(c)(1). Of course, he could rely on the debtor to testify that an exchange was intended, but reliance on this kind of testimony involves more risk than reliance on an easily executed document.
promise which underlies it. Although implementing a far stronger equality principle, Congress overtly sought to protect certain worthy “ordinary course” transactions. In determining the scope of an exception, attempts to circumvent the carefully drawn limitations should of course be avoided. In construing these exceptions, the history of each exception, especially its form in early drafts, will be helpful in determining the types of transactions meant to be covered. More generally, most exceptions have some built-in guarantee that the creditor will transfer reasonably equivalent value to the debtor within prescribed time limits. By the same token, the exceptions do not protect unusual transactions which do violence to the basic equality principle by sanctioning an unfair garnering of the debtor’s assets. In other words, since the section is a compromise between equality of distribution and protection of certain “worthy” activity, the exceptions should not be used to create additional protection for unintended creditors. To the extent that courts encourage creditors to seek section 547(c) protection when they do not actually qualify, other creditors will suffer. The trustee will be forced to expend resources of the estate to fend off imaginative applications of section 547(c).

B. Section 547(c)(1): The Contemporaneous Exchange

1. Collateral

Transfers of collateral which are not simultaneous with the original credit extension and therefore vulnerable under the “strict timing” of section 547(b) are saved by section 547(c)(1) if the parties intended a contemporaneous exchange for new value and the transfer is in fact substantially contemporaneous. This exception has a limited, although perhaps significant, application to transfers of security after a debt has been incurred. The transfer of new collateral in exchange for the release of existing collateral would qualify as a transfer for new value. The exchange, in turn, would be protected under section 547(c)(1) if the transfer was intended to be contemporaneous and was in fact substantially contemporaneous. As al-

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238. 11 U.S.C. § 547(a)(2) (Supp. V 1981). See supra note 217. At least one recent case decided under the new Code contains dicta which states that § 547(c)(1) “is not applicable to situations involving security interests.” In re Christian, 8 Bankr. 816, 819 (Bankr. M.D. Fla. 1981). The court may have intended to state that § 547(c)(1) could not be used to extend the grace period in § 547(c)(3), especially in cases in which the delay in perfection was inexcusable.
ready noted in Part IV, this section applies even if the release and substitution were "precisely contemporaneous" and whether or not the released and substituted collateral have identical values.\footnote{239}

The time for measuring relative equivalency under section 547(c)(1) is the time of the transfer.\footnote{240} The creditor should not lose the protection of section 547(c)(1) if appreciation of the new collateral after the exchange makes it more valuable than the old collateral.\footnote{241}

CASE 10. S held a security interest in D's wood stove to secure a $600 debt. D decided to replace his wood stove with a coal stove of comparable value. S agreed to release his interest in the wood stove in exchange for a security interest in the new coal stove. At the time of this substitution, which occurred during the critical pre-petition period, the wood stove was worth $475 and the coal stove $500. Because of unforeseen market circumstances, the substitute coal stove appreciated in value and was worth $600 on the date of the petition. At that time, the wood stove was worth only $450. The substitution has substantially improved S's position from an undersecured creditor at the time of the exchange to a fully secured creditor in bankruptcy.

Can the trustee avoid any or all of this transfer under section 547? The answer should be no. Acquiring the security interest in the coal stove enables the creditor to "receive more" than he would without the transfer. This, however, would be true under section 547(b)(5) even if the new collateral had been equal in value at the time of the exchange and had not subsequently appreciated.\footnote{242} While admittedly vulnerable under section 547(b), the security transfer in the coal stove is saved by section 547(c)(1) if the creditor can prove the necessary elements. To the extent that section 547(c)(1) required relative equivalence in the exchange, the comparison should be made at the time of the exchange. The slight discrepancy in value between the wood stove and the coal

\footnote{239. The phrase "precisely contemporaneous" is made necessary by the phrase "substantially contemporaneous." The modifiers are both necessary and redundant, since contemporaneous can mean either simultaneous (precisely contemporaneous) or occurring during the same period (substantially contemporaneous). H. FOWLER, W. LITTLE & D. COULSON, THE SHORTER OXFORD ENGLISH DICTIONARY (3d ed. 1973). The drafters obviously meant "substantially contemporaneous" to mean nearly simultaneous.}

\footnote{240. This seems to be required by § 548, although it could be argued that the time of release of the original security is the relevant time. Assuming these times are "substantially contemporaneous," the choice is not critical.}

\footnote{241. See supra note 116. Of course, if the parties knew this would happen, the transfer could be attacked under § 548(a)(1) as an intentional fraud on other creditors.}

\footnote{242. See supra text accompanying notes 224-29.}
stove at the time of exchange should not affect the outcome. Moreover, the subsequent appreciation of the coal stove should not defeat the creditor's section 547(c)(1) defense to a trustee's avoidance action. The elements of section 547(c)(1) focus only on the date of substitution. Although a comparison of liquidation positions is required under the section 547(b)(5) "receives more" test, section 547(c)(1) only requires that the creditor and debtor contemplate a contemporaneous exchange of relative equivalents which is executed in a substantially contemporaneous time frame. Therefore, the trustee cannot avoid any portion of the transfer in this illustration.243

One commentator has suggested that a "relaxed substitution of collateral" doctrine survives in the new Code and is available to assist lenders secured by floating liens.244 This protection would be an alternative to the protection afforded in section 547(c)(5) when inventory or receivables are involved and the exclusive protective theory when collateral other than inventory or receivables is involved.245 Once again the exceptions do not create this protection and the attempts to read case law exceptions back into the section 547(b) definition are misplaced. Even under section 60, the substituted collateral was considered to be taken to secure an "antecedent debt." The origins of the relaxed substitution doctrine followed the reasoning of the section 60 "net result" cases.246 The "relaxed substitution" concept was premised

243. See Kaye, supra note 116, at 200. Kaye's analysis suffers from four misconceptions. First, a judicially created substitution exception should not be read into § 547(b). Section 547(c) is the sole source of exceptions to the operative language of § 547(b). Second, § 547(c)(1) was intended to cover precisely contemporaneous substitutions of collateral, as well as the substantially contemporaneous near miss. There is nothing inadvertent about the application of this section to exact or precise substitutions. Third, the substitution is a § 547(b)(5) preference even if the collateral does not appreciate after transfer. Section 547(b)(5) merely requires that the creditor receive more with the security interest in the new collateral than he would in liquidation without the security interest in the new collateral. Fourth, § 547(c)(1) comes into play if the substitution qualifies when viewed at the time of transfer. The subsequent appreciation of the substituted collateral, viewed at the time of petition, has no bearing on the determination of whether the § 547(c)(1) elements have been met.

244. See P. Murphy, supra note 67, at § 10.14.

245. It is possible to read the Code's definition of "receivables" as used in § 547(c)(5) narrowly to exclude chattel paper and instruments. The better view would include them in the definition. See infra text accompanying notes 301-05. Documents and equipment are more clearly outside the § 547(c)(5) exception. It might be expected that the relaxed substitution concept drawn from prior case law will be advanced by creditors in order to protect replacements of collateral not protected under § 547(c)(1) or § 547(c)(5).

246. See cases cited at 3 Collier on Bankruptcy ¶ 60.21 (14th ed. 1976). See also 2 G. Gilmore, supra note 6, at 1315.
upon the absence of net diminution of the debtor’s estate. As already emphasized, diminution is no longer an element of a section 547(b) preference. Some of the section 547(c) exceptions, including subsections (c)(1) and (c)(5), provide specific protection for transfers that are part of a larger, “no diminution” exchange. Both of these subsections, however, are limited and specific. Under subsection (c)(1), the debtor and creditor must intend that each release and substitution be contemporaneous and each release and substitution must in fact be substantially contemporaneous. Congress has also explicitly limited the protection given to replacements of collateral in floating lien financing arrangements, but the subsection (c)(5) exception applies only to inventory and receivables. Some replacements protected under the old relaxed substitution rule, therefore, will not qualify under subsection (c)(1) or subsection (c)(5). Congress could not have intended to limit the subsection (c)(1) and (c)(5) protections and at the same time provide a broader general exception for all replacement collateral.

2. Payments

Section 547(c)(1) was designed to protect payments as well as transfers of collateral. As a result of the strict timing requirement of section 547(b), a payment for goods or services of equivalent value may be a preference under section 547(b). If the payment does not occur until after value is given, the payment is “for or on account of an antecedent debt.” Therefore, even a technical timing delay in the payment transfer will make it avoidable unless it qualifies for the protection of section 547(c)(1). The payment by check presents special problems under the new Code preference scheme.

Like some of the concepts already explored, the payment by check seems to have been caught somewhere between the structure of the new Code and old Act concepts. Payment by check against concurrent sale

247. See infra text accompanying notes 296-305.
248. See supra text accompanying notes 47-67.
249. The pure cash sale does not involve delayed payment and is not within the § 547(b) definition of a preference.
250. Payments or advances made in after-acquired property financing arrangements are not properly viewed as isolated. Payments to a secured creditor are for the antecedent obligation even if cash is tendered. The question of when payment by check affects a transfer may be an important issue, however, in applying the preference section. The dating of the transfer when a check is used therefore has important, indirect consequences in analyzing secured financing arrangements in bankruptcy.
and delivery has many of the characteristics of a cash sale under state law.\textsuperscript{251} It is not, however, an immediate assignment of funds and it only suspends the underlying obligation for which it is taken.\textsuperscript{252} Because final payment is delayed, a check seems properly viewed as a transfer for an antecedent debt within the strict-timing definition of a preference in section 547(b). Accordingly, section 547(c)(1) is necessary to protect a payment by check.

Unfortunately, the legislative history is confusing. As the preference section acquired its present form, the drafters were clear on their intended treatment of payment by check. In the mark-up minutes to the Drinan substitute to H.R. 6, a payment by check is referred to as "in technical terms, an extension of credit" protected by the exceptions in section 547(c).\textsuperscript{253} The elimination of the artificial grace periods in the definition of antecedent debt created the need for that protection afforded by section 547(c).\textsuperscript{254} Both the House and Senate Reports continued to suggest that section 547(c)(1) was designed to rescue the check from the technical and inclusive reach of section 547(b).\textsuperscript{255}

In subsequent discussions of the bill on the floor, however, Congressman Edwards and Senator DeConcini appeared to refute the reports. In identical statements both men stated that: "Contrary to language contained in the House report, payment of a debt by means of a check is equivalent to a cash payment, unless the check is dishonored. Payment is considered to be made when the check is delivered for purposes of sections 547(c)(1) and (2)."\textsuperscript{256} While purporting to contradict the House Report, these statements are not necessarily inconsistent with the conclusion suggested in the mark-up minutes, House Report, and Senate Report. Section 547(c)(1), not section 547(b)(2), is the proper section for determining whether or not to treat a check as a cash equivalent. The remarks in the Congressional Record, referring to the delivery as the critical date for section 547(c)(1) and section 547(c)(2)

\textsuperscript{251} See U.C.C. §§ 2-507, 2-511.
\textsuperscript{252} See U.C.C. § 3-802.
\textsuperscript{253} MARK-UP MINUTES, supra note 12, at 562 (statement by Mr. Klee in response to an observation by Representative Drinan).
\textsuperscript{254} See supra text accompanying notes 55-67.
\textsuperscript{255} HOUSE REPORT, supra note 12, at 373-74; SENATE REPORT, supra note 12, at 88. Both reports suggest that a check presented within the 30-day period of U.C.C. § 3-503(2)(b) will be a transfer which is "substantially contemporaneous."
purposes, indicate that Representative Edwards and Senator DeConcini might not have appreciated the important technical difference between payment and transfer. 257

Although a contrary position has been taken by knowledgeable commentators, 258 both floor statements stop short of the direct conclusion that the check transfer fails to create a technical "antecedent debt." Such a conclusion would make section 547(c)(1) irrelevant to the treatment of payment by check. Treating a payment by check as a cash transaction would be consistent with section 60 case law, but it is not consistent with the new definition of a preference in section 547(b). 259

The section 547 treatment as a technical antecedent debt follows from the elimination of diminution of the estate as an element of a preference. Under section 60 case law, the check payment was treated

257. See infra note 266.
258. V. COUNTRYMAN, supra note 109, at 270; P. MURPHY, supra note 67, at §§ 10.08, 10.14.
259. The technical delay between the time value is given when a check is used in a cash sale and the time final payment is made by the drawee bank is recognized elsewhere in the new Bankruptcy Code. In particular, this technical delay and its implications are basic to the way in which postpetition payment of a check is handled by § 549 and § 542(c). Section 549 empowers the trustee to avoid unauthorized postpetition transfers, but specifies two kinds of transfers in which a third party transferor is "authorized" to make the transfer even though the trustee may avoid it and recover the funds from the transferee. One of these specially authorized but nonetheless avoidable transfers allows the trustee to avoid postpetition final payment to the payee of a check by the bank of the bankrupt drawer. Under § 549 the payment to the payee is avoidable if it occurs after the commencement of the case, despite pre-petition use of the check by the bankrupt in a "for value" exchange. The bank which disperses the bankrupt's funds after the petition is protected, however, under the limited authority in § 542(c). Under § 542(c), if the bank pays the check in good faith with "neither actual notice nor actual knowledge of the commencement of the case," the bank is treated as if the case "had not been commenced." Section 549 recognizes that, despite the intent of the parties, the mechanics of final payment of a check transform a cash sale by check into a technical antecedent debt, followed by a third party transfer of the bankrupt debtor's property. This protection to the bank, however, provides no shelter to the payee who is the beneficiary of this postpetition transfer. It makes no difference that the check was used in a new value exchange before the petition. In a voluntary case in which the commencement and order for relief are simultaneous, the postpetition transfer to the payee is voidable under § 549(a).

Even if the petition is an involuntary one and the check is paid in the gap between the petition and the order for relief, the transfer to the payee is vulnerable. Section 549(b) protects transfers in this "gap" but only to the extent that value is "given after the commencement of the case in exchange for such transfer." 11 U.S.C. § 549(b) (Supp. V 1981) (emphasis added). If a check is taken in a pre-petition cash sale, the value given cannot be "after the commencement of the case." If the check were deemed to be a transfer when taken by the payee, an anomalous result is possible where an involuntary petition is filed. If the technical antecedent debt were not recognized, the payee who has transferred funds in the gap could be protected from avoidance irrespective of knowledge. At the same time, the drawee bank could be liable for postpetition dealing with the bankrupt's property if the check were paid in the gap after the bank had knowledge of the commencement of the case within the meaning of § 542(c).
like a cash transaction primarily because the estate was not diminished and because the trustee could not demonstrate an intent to extend credit. Transfers that tend to return guaranteed equivalents do not for that reason escape the strict definition of section 547(b). On the other hand, guaranteed equivalent value emerges as a fundamental rationale for the section 547(c) exceptions. The rationale of cases like Engstrom v. Wiley and Dean v. Davis is captured in the section 547(c)(1) exception, not in the section 547(b)(2) definition of an antecedent debt. In fact, the section 547(c)(1) exception incorporates the critical requirement that the parties intend a contemporaneous exchange, not a credit transaction. Therefore, the same substantive protection is provided in section 547(c)(1) as in the old "check-as-cash" case law. The burden of proof, however, is allocated consistently with the trustee's lighter obligation under section 547(b).

Use of a check does in fact delay payment and final discharge of an obligation. A check could be used to take advantage of this delay or to disguise a credit transaction. The trustee should not have to show that a credit extension was intended. His burden should be satisfied by mere proof of the delay. The creditor should then be obliged to show

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260. Engstrom v. Wiley, 191 F.2d 684 (9th Cir. 1951). Although this case interprets state preference law, it is often cited as the leading case for treating payment by check as a cash transaction.
261. Id. at 684.
262. 242 U.S. 438 (1917). For a further discussion of this case, see supra text accompanying notes 55-67.
263. In fact, the legislative history of the § 547(c)(1) and § 547(c)(2) exceptions charts the movement of the protection of "like-cash" transactions from the definition of antecedent debt to the explicit protection of the § 547(c) exceptions.
264. The debtor and creditor can accomplish this in a number of ways. The debtor can use a postdated check or the creditor can agree to delay deposit of the check for collection. Even without this additional delay, a debtor may give a check to the creditor although they both know that there are presently insufficient funds to cover the check. There may be an understanding with the payee, however, that funds will be deposited in time to cover. In all these cases, the transaction is premised on the delay incident to a fund transfer caused by placing the check in collection. If debtor and creditor intended to utilize this delay, they did not intend a contemporaneous transfer so § 547(c)(1) does not apply.

In re Duffy, 3 Bankr. 263 (Bankr. S.D.N.Y. 1980) involved a postdated check where the parties clearly intended a credit transaction. The reasoning used to find transfer at payment rather than at delivery, however, applies generally to all checks. A check itself does not vest in the payee any title to or interest in the funds held by the drawee bank. See U.C.C. § 3-409. The check is simply an order to the drawee bank to pay the sum stated and does not constitute a transfer and delivery of the funds until it is paid. The date of payment, and not the date of delivery, is crucial in determining when the preferential transfer occurred. See also Olsen-Frankman Livestock Marketing Serv., Inc. v. Citizens Nat'l Bank, 4 Bankr. 809 (Bankr. D. Minn. 1980) (applying the Bankruptcy Act of 1898).
that a "like-cash" transaction was intended. The evidence is most accessible to the creditor and the showing can easily be made in most cases. 265

The timing of a transfer when payment is made by check has limited but extremely important significance in the context of after-acquired property financing. The check is often the device by which the debtor will make his payments or the secured creditor will make advances. In the case of the debtor's payment, the existing secured obligation forecloses any argument about whether the payment is "for or on account of an antecedent debt." The resolution of this timing issue, however, can determine whether a transfer occurs within the critical pre-petition period. If a payment by check is a transfer effective at delivery, then checks tendered before the beginning of the critical period would not satisfy section 547(b)(2) even if they were not paid until after the beginning of the critical period. Despite the ambiguous statements made on the House and Senate floors, the transfer under section 547(b) occurs when the check is paid. There is a preference if such payment occurs within the critical period, and other elements of section 547(b) are satisfied. The creditor may prevent avoidance only if he proves all the elements of one of the section 547(c) exceptions. Payments applied toward a prior secured obligation which falls within the critical period because of this delay will generally be avoidable. Section 547(c)(1) will be of no aid to the creditor unless the debtor received new value in exchange for this payment in a transaction which was intended as a contemporaneous exchange. 266

265. While the debtor will wind up with the cancelled check, the creditor should have the sales or service record indicating that a substantially contemporaneous exchange in fact occurred. The creditor's records will normally disclose whether the transaction was treated as one for cash or credit. See In re Hersman, 20 Bankr. 569, 573 (Bankr. N.D. Ohio 1982).

266. The time of payment for § 547(c)(2) purposes might still be when the creditor receives the check. This was the court's position in In re Thomas W. Garland, Inc., 19 Bankr. 920, 928 (Bankr. E.D. Mo. 1982). But see In Re Super Market Distribs. Corp., 25 Bankr. 63 (Bankr. D. Mass. 1982) (transfer of funds must occur within the 45-day period to qualify under subsection (c)(2)). For § 547(c)(4) purposes, however, the words "after such transfer" should be read to refer to the preliminary avoidable § 547(b) transfer, which only takes place when the check is paid. On this point the Garland opinion disagrees. 19 Bankr. at 928.

Likewise, new credit advances by the creditor take effect under § 547(c)(4) when a check is cashed by or paid to the debtor. Klein v. Tabatchnick, 610 F.2d 1043, 1049 (2d Cir. 1979). Delaying the effect of advances will improve slightly the creditor's ability to make use of § 547(c)(4) in those cases where delivery of a check to the debtor occurs before or simultaneously with the acquisition of new collateral or another potentially preferential transfer. If the date the check is paid is
C. Section 547(c)(2): Ordinary Course Payments

The exception in section 547(c)(2) protects recurring credit transactions that are handled by the debtor on a current, ordinary course basis.\textsuperscript{267} Four requirements must be met for the exception to apply. First, the transfer must be in payment of an obligation incurred in the ordinary course of business or financial affairs of the debtor and the transferee. Second, the payment must be made not later than forty-five days after the debt was incurred.\textsuperscript{268} Third, the payment must be made in the ordinary course of business or financial affairs of the debtor and

the date of the advance under § 547(c)(4), the creditor may have an easier time proving that the advance was new value given after the § 547(b) transfer as required by § 547(c)(4).

\textsuperscript{267} 11 U.S.C. § 547(c)(2) (Supp. V 1981) provides:

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;

(B) made not later than 45 days after such debt was incurred;

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

(D) made according to ordinary business terms;

\textsuperscript{268} Congress intended the word "incurred" to relate only to the date the debtor undertook to pay a debt, not the dates on which installment payments incident to the obligation come due. The vast majority of cases have correctly analyzed this issue. See \textit{In re} Chancellor, 20 Bankr. 316, 319 (Bankr. W.D. Ky. 1982); \textit{In re} Iowa Premium Serv. Co., 12 Bankr. 597, 600 (Bankr. S.D. Iowa 1981), aff'd, 676 F.2d 1220 (8th Cir. 1982); Kampf v. Postal Fin., 11 Bankr. 361, 362 (Bankr. D. Minn. 1981); \textit{In re} McCormick, 5 Bankr. 726 (Bankr. N.D. Ohio 1980); \textit{In re} Williams, 5 Bankr. 706, 708 (Bankr. S.D. Ohio 1980). \textit{But see} \textit{In re} Ken Gardner Ford Sales, Inc., 10 Bankr. 632, 644 (Bankr. E.D. Tenn. 1981) (interest obligation incurred when earned). \textit{Cf. In re} Bullen, 11 Bankr. 440, 441-42 (Bankr. W.D.N.Y. 1981) (payment not § 547(b) preference because creditor would have repossessed if payment missed). As in \textit{Ken Gardner Ford}, some creditors have attempted to argue that the interest portion of any payment is covered by the § 547(c)(2) exception. Under this reasoning, the "interest debt" is not incurred until it is earned. This is a perversion of the purpose of the exception, which was designed to protect transfers to such "like-cash" creditors as utilities and trade merchants who bill on a monthly basis. Although the House Report states a general purpose not to disturb "normal financial relations," \textit{see House Report}, \textit{supra} note 9, at 373, the history of the exception indicates a more specific purpose. Earlier versions had specified utilities and trade creditors and employees. House subcommittee staff stated that the section was still designed to apply to "inventory and utilities and paychecks. So that's why forty-five days was picked." \textit{Mark-up Minutes}, \textit{supra} note 12, at 564. It is hardly conceivable that this exception was intended to apply to installment obligations without a specific reference ever being made to these transactions.

This issue was correctly decided by one bankruptcy court and affirmed by the Eighth Circuit. \textit{In re} Iowa Premium Serv. Co., 12 Bankr. 597 (Bankr. S.D. Iowa 1981), aff'd, 676 F.2d 1220 (8th Cir. 1982). One judge dissented, relying on the broad statement contained in the House and Senate Reports concerning "normal financial relations." 676 F.2d at 1222 (Gibson, J., dissenting). Judge Gibson in Iowa Premium, and the court in Ken Gardner Ford both treat the legislative history too

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the transferee. Finally, the payment must be made according to ordinary business terms.

In section 547(c)(2) Congress identified a cluster of payment transfers that are both regular and current. It thereby guaranteed that the creditor provide the debtor with an important equivalent a short time prior to the transfer. Section 547(c)(2) is not, however, a less stringent version of section 547(c)(1). The section 547(c)(2) exception was designed around the narrow concept of the “ordinary course current” transaction rather than a broad concept of “no diminution.” Many of the section 547(c)(2) transfers escaped avoidance under the old Act’s requirement that the creditor have reasonable cause to believe that the debtor was insolvent.269

Perhaps, section 547(c)(2) mistakenly excluded many small unsecured consumer obligations, and some modification of this section may be necessary.270 Commercial financers, however, were never intended beneficiaries of this exception. It may be possible for a secured floating lien creditor to set up an initial payment schedule geared to payment within a period not less than forty-five days following any single advance, or incurred debt. Such a scheme, assuming it is workable, would not survive the “ordinary business terms” requirement of

superficially. The § 547(c)(2) exception was designed to deal with “like-cash” trade creditors, service creditors, utilities and employees paid on monthly, biweekly, or weekly cycles.

It is not always easy to determine when a debt is incurred. For purposes of installment obligations, the debt is incurred when the original obligation is incurred. It is far more difficult to determine when a utility “debt” is incurred, when the service is supplied or when the monthly use is tabulated. At least one court has chosen the latter, at least for an electric bill, reasoning that there is no way to actually determine daily supplies of electricity. Compare In re Thomas W. Garland, Inc., 19 Bankr. 920, 927-28 (Bankr. E.D. Mo. 1982) with In re Dickey & Sons, Inc., 11 Bankr. 146, 147-48 (Bankr. N.D. Tex. 1980). This result is justified, although the legislative history indicates that Congress chose 45 days to provide further reasonable time after the bill containing a month’s charges was received. Note also the possible application of § 547(c)(4) if credit service is continuing. In re Hersman, 20 Bankr. 569 (Bankr. N.D. Ohio 1982). The provisions of § 547(c)(2) seem to be overly restrictive. See 1981 Reform Act Hearings, supra note 15, at 158, 244-45, 254-55. See, e.g., In re Chancellor, 20 Bankr. 317 (Bankr. W.D. Ky. 1982). See also Fortgang & King, supra note 15, at 1167.

270. There has been some justified criticism of this subsection. See supra note 15. The real cause for complaint, however, is limited to those types of transactions, such as payments for credit card purchases, which were targeted for protection but don’t quite qualify under the 45-day time limit. Proposed changes in § 547, such as those contained in S. 2000, which would protect all regular payments, go too far and drastically undermine the entire preference scheme. Any properly conceived modification of subsection (c)(2) should protect only those “like-cash” transactions presently unprotected by (c)(2), including utility payments or payments for credit card purchases made during the current billing cycle.
Furthermore, if the scheme represented an alteration of existing credit terms, in response to a perceived financial weakness in the debtor, neither the incurring of the debt nor its payment would be in the ordinary course.

D. Section 547(c)(3): Enabling Loans

The transfer of a security interest in collateral incident to a purchase money or enabling loan is, if certain requirements are met, protected under section 547(c)(3). First, the loan or other credit must not occur before the security agreement is executed. Second, the loan or other credit must be given by the secured party to enable the debtor to acquire the collateral. Third, the loan proceeds must in fact be used to acquire the collateral in question. Fourth, the security interest must be perfected “before 10 days after such security interest attaches.” This

271. See supra text accompanying notes 40-67. See also Mark-up Minutes, supra note 12, at 566-67. Staff counsel, Mr. Klee and Mr. Levin, emphasized that a payment to the creditor had to be according to the ordinary terms common to the industry. A secured commercial installment lender could not create an arrangement which would both qualify under the subsection (c)(2) time frame and be made according to ordinary business terms. Nor can the creditor argue that the debt is incurred when the payment is due. See supra cases cited at note 268. But see In re Ken Gardner Ford Sales, Inc., 10 Bankr. 632, 646-48 (Bankr. E.D. Tenn. 1981) (interest accruing to a floor plan financier within 45 days protected).


The trustee may not avoid under this section a transfer—

(iii) of 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 before 10 days after such security interest attaches.

273. The limiting reference to the signing of a security agreement would apparently exclude security interests which satisfy U.C.C. § 9-203 without a written security agreement because the creditor has possession of the collateral. This might simply be a drafting oversight. There is no reason to treat differently the rare case of an oral agreement and a possessory security interest. It is highly unlikely, however, that a purchase money loan will be made with an oral agreement for creditor possession instead of a written security agreement.

274. The Technical Amendments would make the 10-day period in § 547(c)(3)(B) conform to the U.C.C. period. See infra note 277. The general 10-day grace period in § 547(e)(2) remains the same, terminating 10 days after the transfer takes effect. If the debtor already has rights in the collateral under § 547(e)(3), the § 547(e)(2) period runs from attachment. If amended, the subsection (c)(3)(B) period would run from possession of such property by the debtor. The debtor could conceivably obtain possession before or after transfer of the security interest. For example, if the credit extension and transfer of collateral are simultaneous but delivery of the collateral to the
exception is not made necessary by the ten-day grace period in Article 9 for perfecting many purchase money interests. Instead, a grace period for all security interests is provided in section 547(e). The ten-day grace period in section 547(e), however, merely allows for a relation back to the moment that the transfer of collateral takes effect. Section 547(e)(3) provides that the transfer cannot be made until the debtor has rights in the collateral transferred. Whenever the enabling loan occurs before the debtor acquires such rights, as it often would, the section 547(e) grace period would not prevent the subsequent collateral transfer from being "for or on account of an antecedent debt." Section 547(c)(3), therefore, is made necessary by the strict timing rules in sections 547(b)(2) and 547(e)(3), which make effective transfer possible only after or at the moment the debtor has acquired rights in the property.

debtor is delayed by three days, a filing made nine days after delivery would not relate the perfection back under § 547(e)(2) because more than 10 days has elapsed since the "transfer" took effect. The filing does, however, meet the requirements of the enabling loan exception in § 547(c)(3).

On the other hand, the debtor may have possession of the seller's property before the decision to purchase on credit is made and before a security interest in the collateral is created. In such a case the 10-day period under the proposed amendment to § 547(c)(3)(B) should begin to run from ostensible possession. Thus, the secured seller would still have 10 days from the attachment of the security interest. He would be protected by the grace period in § 547(e)(2), which would relate the transfer back to the time of credit extension and creation of the security interest. As long as the credit extension did not predate the creation of the security interest, the transfer would not be for antecedent debt. Section 547(c) would not apply because there would be no preference. If there were a gap between credit extension and creation of a security agreement, the proposed § 547(c)(3)(B) would limit the creditor's protection. The § 547(c) exception would not apply unless perfection occurred within 10 days of the debtor's possession of "such property."

The use of the phrase "such property" in proposed § 547(c)(3)(B) eliminates for bankruptcy purposes a dispute which has arisen under U.C.C. § 9-312(3). Some have successfully argued that property received but not yet owned by the debtor prior to sale and creation of the security interest was not "collateral" until the conditional sale was executed. Therefore, the 10-day period did not begin to run until that time. See Brodie Hotel Supply, Inc. v. United States, 431 F.2d 1316 (9th Cir. 1970); Cain v. Country Club Delicatessen, Inc., 25 Conn. Supp. 327, 203 A.2d 441 (Conn. Super. Ct. 1964).

276. See supra text accompanying notes 81-112.
277. At present the 10-day period in § 547(c)(3)(B) does not coincide with the grace period provided for purchase money interests in Article 9. In U.C.C. § 9-301(2) the 10-day period begins to run from the time "the debtor receives possession of the collateral." The protection offered by the grace period under the Uniform Commercial Code does, however, run from "attachment" to filing. The § 547(c)(3)(B) requirement is that perfection occur before 10 days after attachment. The Technical Amendments contain a provision aimed at making the § 547(c)(3)(B) time period conform to the time period in U.C.C. § 9-301(2). S. REP. No. 150, 97th Cong., 1st Sess. 74 (1981).

Some states have nonuniform versions of § 9-301(2) that give the creditor a grace period longer than 10 days. It can be argued that these longer state law grace periods operate to retroactively
A secured creditor with a “floating” interest in all of the debtor’s after-acquired inventory may be the supplier who is selling the inventory on credit. To a certain extent, subsections (c)(2), (c)(3), and, (c)(5) each provide necessary protection for transfers incident to a normal financing pattern. Similarly, a secured lender with a “floating” interest in the debtor’s inventory may make a loan for the purpose of enabling the debtor to acquire specific items of additional inventory. Again, more than a single exception might be applied. Although no single transfer can be protected more than once, the overlapping coverage of either subsection (c)(1) or (c)(3) with subsection (c)(5) can create confusion. Section 547(c)(5) would protect all inventory transfers to the extent that the gap between debt and collateral has not been narrowed to the prejudice of other creditors. Transfers that narrow the gap are unprotected: If discrete collateral transfers are protected

“perfect” transfers to the date they take “effect” within the meaning of § 547(e)(1)(B) and § 547(e)(2)(A). Congress, however, seems clearly to have intended the perfection definition to be modified only by the uniform grace period in § 547(e)(2)(A). The only relation back envisioned by Congress was in § 547(e)(2)(A). Despite the clear evidence of congressional intent on this point, at least one court has read a longer state law grace period into what becomes a retroactive definition of “perfection” in subsection (e)(1)(B). In re Burnett, 14 Bankr. 795 (Bankr. E.D. Tenn. 1981). Burnett is a stunning judicial tour de force. Judge Kelley recognized that Congress intended the 10-day grace period to operate uniformly making state grace periods irrelevant. Id. at 801 Nevertheless, he held that a security interest perfected 20 days after it actually took “effect” relates back so that the trustee does not meet the antecedent debt requirement. The holding is based on the conclusion that incorporating the state grace period into the meaning of “perfection” in § 547(e) is “less troublesome than the interpretation that agrees with Congress’ intent.”

In a normal financing pattern, the security interest in the new collateral secures prior and future obligations, as well as the credit extension incident to its sale. Therefore, if the security agreement contains a cross-collateral clause, each transfer of collateral will satisfy the § 547(b) element of a preference requiring the transfer to be for or on account of an antecedent debt, even if it is simultaneous with the credit extension. Thus, the creditor will have to prove the applicability of one of the § 547(c) exceptions. This relieves the trustee of having to determine which credit extensions have been extinguished and whether a specific item of collateral secures prior, contemporaneous or subsequent credit extensions.

279. The purchase money seller would be adequately protected by either § 547(c)(1) or § 547(c)(3). The purchase money lender is the party who will more often find it necessary to resort to § 547(c)(3), which was designed to protect him. If there is any significant gap between the loan and the acquisition of the collateral, the lender will not be protected by § 547(c)(1), but will be protected by § 547(c)(3) if all requirements are met. In both cases § 547(c)(5) will also afford protection for collateral transfers in inventory.

A secured creditor may also release collateral for sale outside the ordinary course in exchange for the purchase of new collateral, a substitution also protected by § 547(c)(1) and to an extent by § 547(c)(5).

under subsection (c)(1) or (c)(3), how is the final section 547(c)(5) gap to be figured? Consider the following illustration:

CASE 11. S is a secured creditor holding a security interest in all of D's inventory. On January 1, D owed S $100,000 and had $80,000 in inventory. To help D with his financial problems, S agreed to lend D an additional $20,000 to enable him to purchase and sell a new line of silver widgets. S loaned the $20,000 and filed a financing statement on January 3. On January 14, D purchased $20,000 worth of silver widgets which were delivered on January 16. Unfortunately D's poor financial condition prevented him from effectively attempting to advertise or market these silver widgets. Other inventory was bought and sold until the beginning of March, when D's activities virtually ceased. D filed a bankruptcy petition on April 1. At that time S was still owed $120,000. Due to a change in the price of silver and favorable market conditions for the new silver widgets, those widgets were now worth $30,000. The value of all D's inventory is $115,000.

To what extent are those collateral transfers avoidable? Does S have an option to choose which exception protects any of these transfers? Must S choose? To begin, it is necessary to note the possible solutions. If section 547(c)(3) is ignored when section 547(c)(5) is applicable, then the transfer of collateral incident to the enabling loan is protected along with the other transfers to the extent that the gap is not narrowed to the prejudice of other creditors. It seems unlikely that the enabling loan and transfer of the resulting purchase money interest would cause any reduction in the gap. In this case, however, the gap between the secured debt and the value of the inventory has been reduced by $15,000, but $10,000 of this reduction was caused by an unexpected appreciation of the purchase money collateral. This mere appreciation probably does not cause "prejudice" to other creditors. The creditor, however, carries the burden of proof on all the section 547(c)(5) elements, including the lack of prejudicial effect.281 If the transfer is protected under section 547(c)(3), however, the creditor need only show that a section 547(c)(3) enabling loan existed at the time of transfer. Once the elements of section 547(c)(3) are proved, the transfer is protected without any further explanatory proof if the property appreciates.282

The choice for the creditor is simple. If collateral has not appreci-

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281. See supra note 76. For a discussion of prejudicial effect, see infra text accompanying notes 313-19.
282. The same applies if the transfer is protected under § 547(c)(1). The creditor need only prove the necessary elements of the contemporaneous exchange subsection.
ated, the creditor will probable resort solely to section 547(c)(5), since he need only show the level of debt, the value of collateral and that the collateral is inventory. If some collateral has appreciated, the secured creditor can decide whether it will be easier to prove the elements of section 547(c)(3) as opposed to proving the absence of prejudicial effect.

Once the creditor chooses to seek the protection of subsection (c)(1) or (c)(3), it is necessary to establish how the section 547(c)(5) gap will be calculated. According to the legislative history, exceptions apply independently to specific transfers and application of one does not preempt the application of others. Therefore, it seems logical to exclude subsection (c)(1) and (c)(3) collateral transfers before arriving at the final value of collateral in the section 547(c)(5) calculation. At the same time, the debt owed to the creditor has been increased by the "new value" given in the transfer protected under either section 547(c)(1) or section 547(c)(3). To prevent distortion, this increase in debt must also be excluded.

In Case 11, $S$ would have two options. $S$ could seek only the protection of section 547(c)(5). The gap, originally $20,000, would initially appear to be reduced to $5000 ($120,000-$115,000). This would enable the trustee to avoid $15,000 in collateral transfers. $S$, however, could further prove that the $10,000 reduction caused by appreciation was not to the prejudice of other creditors. Thus the trustee only avoids $5000 in collateral transfers.

$S$ could alternatively prove that the transfer of the purchase money interest was covered by the section 547(c)(3) exception. In that case, the value of the purchase money collateral at petition is excluded from the section 547(c)(5) calculation. The credit extension incident to that transfer is also excluded. After excluding those items, the value of collateral is $85,000 ($115,000 - $30,000) and the debt secured figure is $100,000 ($120,000 - $20,000). The gap at petition is $15,000, a reduction of $5000. Thus the trustee can still avoid $5000 in collateral transfers.

### E. Section 547(c)(4): Subsequent New Credit

Unlike the other section 547(c) exceptions, section 547(c)(4) does not
focus on the transfer protected. Instead it allows the creditor to protect any transfer avoidable under section 547(b) to the extent of subsequent, unsecured and unconditional new value. The premise of section 547(c)(4) is the creditor has already restored what he has taken as a preference. The premise is borrowed from the old statutory net result rule in section 60(c) of the Act. Section 547(c)(4) has eliminated some of the problems of section 60(c) which unfairly denied a set-off to some creditors. In this sense it is more generous than section 60(c). The most significant change was the elimination of the "remaining unpaid" condition of section 60(c). When section 60(c) was applied literally, payments during the four-month pre-petition period were often applied in payment against advances, thus making them ineligible for section 60(c) credit. At the same time, the trustee attempted to avoid these payments. The creditor lost both the section 60(c) credit and the payments which caused the loss of credit. Paradoxically, a creditor could have been in a better position if he did not receive payments during the critical period. This problem could have been easily avoided if courts had simply stated that the credit remained unpaid if the payment was itself avoidable. Instead, the problems were probably seen

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The trustee may not avoid under this section a transfer—

(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.

285. See supra note 181.

286. For an excellent analysis of this problem, see Note, supra note 181, at 297-300. A creditor would be most vulnerable if he entered the critical period owing a relatively small amount of money. Payments would quickly extinguish that debt and would begin to be applied against the advances. The advances would be deemed paid even though the trustee could avoid these payments. Grandison v. National Bank of Commerce, 231 F. 800 (2d Cir.), cert. denied, 242 U.S. 644 (1916). Similarly, the creditor would be caught in the same paradox if he and the debtor agreed to apply payments first against the most current advances. Note, supra note 181, at 300. If the creditor was not paid, he could be in the same position as the recipient of a voidable preference which had to be returned. The trustee, however, could no longer make the argument that the subsequent credit had been repaid for purposes of § 60(c).

287. One court recognized this paradox and avoided the result by refusing to allow the trustee to avoid the payment of advances which would have otherwise been available for § 60(c) credit. In re Ace Fruit & Produce Co., 49 F. Supp. 986, 989-90 (S.D.N.Y. 1943). The court did not notice the apparent conflict with Grandison v. National Bank of Commerce, 231 F. 800 (2d Cir.), cert. denied, 242 U.S. 644 (1916). The § 60(c) discussion in Grandison is rather abbreviated and perhaps should not be given much weight. The credit, however, was repaid from two different sets of assigned accounts and the trustee successfully avoided one assignment as a preference. Nonethe-
as a justification to circumvent the limitations of section 60(c) by doctrines such as the case law net result rule. The section 547(c)(4) exception takes the easier, more direct route which clearly specifies the extent of protection. The set-off for new value given is available to the extent that the debtor does not on account of the new value “make an otherwise unavoidable transfer to or for the benefit of such creditor.”

The section 547(c)(4) exception is otherwise substantially similar to section 60(c). The extent of new value for which a set-off is available must occur after the preferential transfer, an important limitation rendering the case law net result rule a nullity. The operation of this limitation is demonstrated by the following illustrations:

CASE 12. On January 1, D owed S, an unsecured creditor, $5000. On January 3, D made a payment of $1000 to S. On January 10, S extended an additional $4000 credit to D. On January 17, D paid S $3000. On February 15, S extended an additional $1000 credit to D. On April 1, the bankruptcy petition was filed.

CASE 13. On January 1, D owed S, an unsecured creditor, $5000. On January 3, D made a payment of $3000 to S. On January 10, S extended an additional $2000 credit to D. On January 17, D made a $1000 payment to S. On February 15, S extended an additional $2000 credit to D. On April 1, the bankruptcy petition was filed.

What can the trustee avoid in each case? If the discredited case law net result rule of section 60 were applied, the trustee could not avoid any payments in either case. In both illustrations, credits during the critical period equalled or exceeded payments. This is not, however, how section 547(c)(4) operates. In Case 12, the trustee may avoid $2000, because section 547(c)(4) only provides a set-off to the creditor of $2000. The January 10 credit extension can only offset the prior preference of $1000 on January 3. The February 15 credit extension of $1000 can offset $1000 of the January 17 preference. However, $2000 of that preference remains unprotected and avoidable.

In Case 13, the trustee cannot avoid any payments. The January 10 credit extension of $2000 is a partial set-off against the prior (January

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288. Note, supra note 181, at 298 n.29.
preference of $3000. The February 15 credit extension of $2000 is set-off against the prior (January 17) preference of $1000 and against the $1000 portion of the prior (January 3) preference which has not yet been cancelled.

In one significant respect, section 547(c)(4) readopts by express language section 60(c) case law. In a significant section 60(c) opinion, *In re Hygrade Envelope Corp.*, the Second Circuit applied the requirement that qualifying credit be “without security of any kind.” The court rather carefully attempted to determine to what extent advances were actually secured at the date of petition. New credit was not secured to the extent that the security was either avoidable or actually necessary for other prior secured debts. The approach of this case is expressly found in the requirement of section 547(c)(4)(A) that the new value not be secured by “an otherwise unavoidable security interest.” In *Hygrade*, the court successfully struggled with the calculations necessary by this approach. In the new preference scheme, there are no additional difficulties unless the collateral is covered by section 547(c)(5). When, however, the collateral is inventory or receivables, the degree of protection afforded by section 547(c)(5) will affect the degree to which advances are secured.

Other modifications are minor, although they sometimes create new puzzles. One change is the substitution of new value in section 547(c)(4) for new credit in section 60(c). The section 60(c) exception was clearly designed to cover new loans, goods, or services. The definition of new value includes a “release of property previously transferred that is neither void nor voidable.” This would include the release of an unavoidable security interest. At the same time, section 547(c)(4) requires that the new value be unsecured. This may indicate that the...

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291. 393 F.2d 60 (2d Cir.), cert. denied, 393 U.S. 837 (1968).
292. Bankruptcy Act § 60(c).
294. For a discussion of the integration of §§ 547(c)(4) and 547(c)(5), see *infra* text accompanying notes 323-46. A theory of integration is made necessary because §§ 547(c)(4) requires a determination of available security while §§ 547(c)(5) requires a determination of the extent to which payments are avoidable. This latter determination is necessary to fix the “debt secured” figure in calculating the § 547(c)(5) gap.
295. One minor adjustment was the elimination of the requirement that new credit be given in good faith; it was never clear what this requirement of § 60(c) was trying to prevent.
drafters never considered whether releases of collateral should qualify for subsection (c)(4) credit. Nonetheless, the new value definition is clear and there appears to be no good reason to ignore it. The trustee and court, however, should be careful that the security released was "neither void nor voidable."

If the collateral was not inventory or receivables, the question is simply whether the released collateral, viewed from the date of petition, would have been available to the creditor or whether the original transfer of collateral could have been avoided. When the collateral is inventory or receivables, the situation is somewhat more difficult. The limit on section 547(c)(5) protection focuses on the net effect of all inventory or receivable transfers rather than specific transfers. In contrast, the section 547(c)(4) exception, if releases of security are within its scope, focuses on specific releases. A creditor could conceivably attempt to utilize this contrast to gain additional section 547(c)(5) protection. Consider the following illustration:

**CASE 14.** D owed S $100,000. This debt is secured by D's automobile inventory. On January 1, D has five automobiles worth $10,000 each. During the week of January 7, he sells three automobiles. A week later he acquires seven new automobiles, each worth $10,000. Soon afterwards, D's activities virtually cease. On the eve of bankruptcy, C releases his security interest in the two automobiles which D had acquired prior to January 1. On April 1 a petition is filed. The debt is still $100,000.

What can the trustee avoid? If S had not released the collateral, the trustee would have been able to avoid the transfer of security in four automobiles because the section 547(c)(5) gap of $50,000 ($100,000-$50,000) would have been reduced to $10,000 ($100,000-$90,000). Because of the release, the gap has been reduced to $30,000 ($100,000-$70,000), a reduction of only $20,000 ($50,000-$30,000). Applying only subsection (c)(5), the trustee can avoid the $20,000 improvement. The creditor, however, might try to argue that the $20,000 release of collateral also justifies a $20,000 subsection (c)(4) credit which would prevent the trustee from avoiding the $20,000 subsection (c)(5) improvement. The creditor would argue that the preferential collateral transfers which do not qualify under subsection (c)(5) ($20,000) occurred prior to the release, or new value. Furthermore, the collateral released was the subject of an unavoidable security interest because the two automobiles released were acquired before the critical period. This argument has a seductive but superficial logic.
Absent the release, other collateral transferred within the critical period would have lost section 547(c)(5) protection. On the date of petition, it is apparent that the release helped validate additional security interests. In this sense, the new value, or release, was "secured" by an unavoidable security interest as prohibited by section 547(c)(4)(A). If section 547(c)(4) is to be sensibly applied to all new value, including such releases, the section 547(c)(4) credit should not be available to give the creditor a windfall.

Finally, it should be noted that the date of the petition is the critical date under section 547(c)(4) for determining whether a release of collateral qualifies as new value, that is, whether the security interest released would have been unavoidable. The date of the petition is also critical in determining whether a release is itself "secured" for section 547(c)(4)(A) purposes, that is, whether it helps to validate additional section 547(c)(5) collateral. At the same time, the date new value is given is critical in determining whether new value was given after the preferential transfer.

F. Section 547(c)(5): The Floating Lien

1. The Scope of Section 547(c)(5) and its Relationship to the Definition in Section 547(b)

Among the most significant changes in the Code is the section 547(c)(5) compromise designed to deal specifically with the floating lien. This compromise was accomplished by first anchoring the transfer of any discrete item over which the creditor's interest "floats" to the time when the debtor obtained rights in that item. As a result, all collateral obtained during the critical period, unless superfluous, re-

The trustee may not avoid under this section a transfer—

(5) of 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 exceeded the value of all security interests for such debt on the later of—

(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.

(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; and

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

results in a section 547(b) preference. Section 547(c)(5) then excepts all transfers of perfected security interests in inventory, receivables or their proceeds, subject to limitations, from trustee avoidance. The key limitation removes protection “to the extent that the aggregate of all such transfers . . . caused a reduction, as of the date of the filing . . . to the prejudice of other creditors holding unsecured claims, of any amount by which the debt secured by such security exceeded the value of all security interests . . .” at the beginning of the critical period.

In other words, section 547(c)(5) requires a two point comparison of the gap between debt and collateral. The apparent mathematical simplicity of section 547(c)(5) is deceptive. The important qualifying language of section 547(c)(5) must be understood before it can be sensibly applied. First of all, the basic scope of the exception is tied to the definition of inventory, receivables and their proceeds—a definition which is not clear. Furthermore, the key limitation, the two point comparison, contains two important qualifications. Reductions in the gap must be caused by transfers of security in these items, and the reduction must prejudice unsecured creditors.

Inventory and receivables are defined in section 547(a). The key

298. See supra text accompanying notes 141-44.

299. For insiders with “reasonable cause to believe,” the first point is generally one year. For others, the first point is generally 90 days. If new value is given for the first time during the critical period, the first point for both insiders and others is the date on which new value is given. In this case, the value of collateral at the first point of comparison will be the value of collateral in which the debtor already has rights at the time value is first given.

300. The first qualification has escaped at least one court purporting to apply § 547(c)(5). In In re The Music House, Inc., 11 Bankr. 139 (Bankr. D. Vt. 1980), the trustee challenged a preferential payment of $214 made to an undersecured creditor during the 90 day period. The court rejected the trustee’s challenge because the trustee failed to show that the payment improved the creditor’s position under subsection (c)(5). Id. at 140-41. Payments are not protected at all under subsection (c)(5). Furthermore, the Music House case places upon the trustee the “burden of proving by a fair preponderance of all evidence every essential controverted element resulting in the composite preference,” including the burden of showing the secured creditor’s position was improved. Id. at 140. This seems contrary to the allocation suggested by the legislative history of § 547(c). See supra note 76.

301. 11 U.S.C. § 547(a) (Supp. V 1981) provides:

(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) “receivable” means right to payment, whether or not such right has been earned by performance.
difficulty is determining whether instruments and chattel paper are covered by the definition of a "receivable." Despite some support for the view that chattel paper and instruments are not covered, these forms of collateral are within the definition of collateral protected by section 547(c)(5). While earlier drafts contained language more closely resembling a standard definition of accounts, the section 547(a) definition includes all rights to payment. Moreover, the section 547 definition is nearly identical to the UCC definition of an account, without the UCC's explicit exclusion of instruments and chattel paper. Because the drafters of the UCC thought an express exclusion was necessary to remove these items from the intentionally broad definition of accounts, the elimination of the excluding language from section 547(a)(3) evidences an intention to include these items. Most important, inclusion of these types of collateral is wholly consistent with the purpose of section 547(c)(5), which is to give limited protection to collateral that by its

302. See V. Countryman, supra note 109, at 288. The authors of this casebook rely on the fact that "the term was taken, and the definition adapted, from the draft bill proposed by the National Bankruptcy Conference." See Gilmore Committee Report, supra note 9, § 60(a)(5)(iv), at 211. The Committee apparently intended the definition to be identical with the U.C.C. § 9-106 definition of accounts. The definitions in the Commission and Judges' Bills were substantially identical. The final definition, however, was significantly altered. See infra note 303.

It is not clear why the Gilmore Committee excluded chattel paper and instruments. Apparently, they believed that "'inventory' and 'receivables' are where the action has been . . . " and that "sleeping dogs should be left undisturbed." Gilmore Committee Report, supra note 9, at 215.

303. The National Bankruptcy Conference version defined receivables as "claims to money for the transfer or use of property or for the furnishing of services, whether or not the claims have been earned by performance." Gilmore Committee Report, supra note 9, § 60(a)(5)(iv), at 211 (emphasis added). The Commission and Judges' Bills defined a receivable as "any right to money for the transfer or use of property . . . whether or not the right has been earned by performance," Commission Report (pt. 2), supra note 8, at 168 (emphasis added). The version adopted by Congress in § 547(a)(3) simply is "any right to payment, whether or not such right has been earned by performance." 11 U.S.C. § 547(a)(3) (Supp. V 1981) (emphasis added).

The difference between the claim or right to money and the right to payment has great significance. U.C.C. § 9-105 defines "instrument" as a negotiable instrument in Article 3, or a certified security as defined in Article 8, or "any other writing which evidences a right to the payment of money." If Congress had intended to exclude writings which evidence the right to payment from § 547(a)(3), they could have retained the word "money" in the definition.

304. The Uniform Commercial Code defines "account" as "any right to payment for goods sold or leased or for services rendered which is not evidenced by an instrument or chattel paper, whether or not it has been earned by performance." U.C.C. § 9-106 (emphasis added).

With the exception of the substitution of "such" for "it," the § 547(c)(3) definition is identical to the italicized portion of the Uniform Commercial Code definition of accounts. Because Congress dropped the exclusion, it is reasonable to assume that it intended to include those items excluded by the unitalicized portion of the Commercial Code definition.
nature "turns over."\textsuperscript{305} The trustee's power to avoid is limited to reductions in the gap caused by transfers of specified collateral. The gap might also be reduced by payments which result in a lowering of the debt on the date of petition. To the extent the gap is reduced by the debtor paying the debt, the reduction is not caused by transfers of specified collateral. Such payments should be recovered separately under section 547(b) because section 547(c)(5) does not protect payments at all. On the other hand, such payments do not reduce the protection afforded to collateral transfers under section 547(c)(5). Consider the following illustration:

CASE 15. The secured party, \textit{S}, had a floating security interest in \textit{D}'s inventory. On January 1, the inventory was worth $50,000 and \textit{D} owed $100,000. During the next ninety days, \textit{D} sold $30,000 in inventory and acquired $50,000 in inventory. \textit{D} also made payments to \textit{S} totaling $20,000. \textit{S} extended no further credit. On April 1, a petition is filed. \textit{D} owns $70,000 in collateral and apparently owes \textit{S} $80,000.

What can the trustee avoid? What is protected by section 547(c)(5)? To begin with, the order in which inventory was acquired and sold during the critical period has no bearing. Fluctuations in the gap are not relevant under section 547(c)(5). The gap need only be measured at the two points of comparison.\textsuperscript{306} The original gap, ninety days before

\textsuperscript{305} An interesting, although minor problem, arises under the term "proceeds," which is not defined for § 547(c) purposes. Under U.C.C. § 9-306, proceeds "includes whatever is received upon the sale, exchange, collection or other disposition of collateral or proceeds." Article 9 case law has supported the use of tracing in order to identify proceeds in nonseparate bank accounts, as required by § 9-306(2), for the continuation of a security interest. See, e.g., Michigan Nat'l Bank v. Flowers Mobile Homes Sales, Inc., 26 N.C. App. 690, 217 S.E.2d 108 (1975).

When the debtor is in bankruptcy, however, the creditor's traceable rights in nonseparate accounts ceases. Instead, the creditor receives the statutory substitute defined in § 9-306(4)(d). In a notable opinion, the Ninth Circuit declared the § 9-306(4)(d) interest to be a preference under § 60 of the old Bankruptcy Act. In re Gibson Prods., 543 F.2d 652 (9th Cir. 1976), cert. denied, 430 U.S. 946 (1977). Of course, the Ninth Circuit broadly defined the substitute award available under U.C.C. § 9-306(4)(d). Moreover, the § 9-306(4)(d) award was only preferential to the extent it exceeded the traceable proceeds. 543 F.2d at 657. See also In re Dexter Buick-GMC Truck Co., 2 Bankr. 242 (Bankr. D.R.I. 1980).

Regardless how § 9-306(4)(d) fared under § 60, it may have greater difficulty under the Code. It is not certain that the § 9-306(4)(d) interest would be considered as "the proceeds" of inventory or receivables for § 547(c)(5) purposes. Moreover, it may very likely be considered a statutory lien under § 545(1)(A) or (B). For an opinion to the contrary, see J. WHITE & R. SUMNERS, UNIFORM COMMERCIAL CODE 1017 (2d ed. 1980).

\textsuperscript{306} The final language of § 547(c)(5) retains the policy derived from the Commission Report that "[i]ntervening fluctuations in the relationship between debt and collateral during the [three] month period [should be] ignored. . . ." COMMISSION REPORT (pt. 1), supra note 8, at 209; GILMORE COMMITTEE REPORT, supra note 9, at 216.
the petition, was $50,000 ($100,000-$50,000). On the date of bankruptcy, the apparent debt is $80,000 and collateral is worth $70,000. That gap has been reduced by $40,000. Can the trustee avoid $40,000 in security interests? Section 547(c)(5) protects all transfers of specified collateral up to the point that the transfers cause a reduction in the gap. Transfers beyond that point, those which cause a reduction, may still be avoided. In Case 14, only $20,000 of the reduction was caused by collateral transfers. Therefore, $20,000 in collateral is avoidable. The payments caused the further reduction. The $20,000 in payments are recoverable as preferences under section 547(b).

The trustee might attempt to avoid additional collateral transfers in such cases by ignoring the effect of avoided payments on the level of debt important to the section 547(c)(5) calculation. Consider the following illustration:

CASE 16. On January 1, D owed S $100,000, secured by a floating lien on D's inventory. At that time, the inventory was worth $50,000. On January 5, D acquired $50,000 in additional inventory. Thereafter, approximately $50,000 in inventory was sold and $50,000 in inventory was acquired. On January 15, S loaned $50,000 to D. On March 1, D paid S $50,000. On April 1 a petition was filed.

What can the trustee avoid? On the date of bankruptcy, the debt appears to be the same as ninety days previous ($100,000) and collateral has grown in value by $50,000 to $100,000. The gap appears to have narrowed by $50,000 to zero ($100,000-$100,000). The $50,000 payment made on March 1, however, can be avoided. Because the $50,000 advance on January 15 was prior to the preference of March 1, none of this preferential payment is protected by section 547(c)(4). The trustee might argue that the exception in section 547(c)(5) makes $50,000 in collateral transfers avoidable regardless of what payments can be recovered. In other words, the trustee might attempt to peg the "debt secured" figure at bankruptcy at $100,000 for purposes of computing the section 547(c)(5) gap. Such a reading of the section would permit an unwarranted double recovery and the statute does not require it. Instead, the debt on the date of bankruptcy should be adjusted upward to the extent that preferential payments are recovered. These recovered payments have the effect of raising the creditor's bankruptcy

307. These prior advances cannot be set off against subsequent preferential transfers under § 547(c)(4) and should not be protected under a net result rule derived from the cases interpreting the language transplanted from old § 60. See supra text accompanying notes 161-207.
claim and the gap should be measured using that adjusted amount in applying section 547(c)(5).\textsuperscript{308} In Case 16, the $50,000 payment is recoverable and the adjusted debt, the “debt secured” figure, should be $150,000 for purposes of section 547(c)(5) ($100,000 + $50,000). Collateral at bankruptcy is worth $100,000. The gap, therefore, is the same as it was ninety days before bankruptcy ($50,000). The trustee, having recovered the $50,000 payment, does not have a claim to any collateral and he does not recover twice for the same improvement in the creditor’s position.

This integration of sections 547(b) and 547(c)(5) is consistent with the policy of section 547(c)(5): to protect collateral transfers in specified collateral as long as the creditor’s position is not improved. Moreover, this integration has the further advantage of permitting the trustee to get cash first. The creditor, having lost the cash, keeps collateral in its stead, an asset for which he has bargained by securing his debt and for which he has the responsibility of oversight and maintenance.

The fact that section 547(c)(5) only protects collateral transfers suggests the proper course of action for secured creditors dealing with a financially troubled debtor. The creditor must closely monitor the debtor and exert tighter control over collateral. Most standard security agreements contain a requirement of a certain collateral-to-debt ratio—often in excess of 1:1. A debtor who is not carefully policed may sell off collateral or liquidate accounts when experiencing extreme financial difficulty.\textsuperscript{309} If the creditor belatedly discovers that he has become undersecured, he might force the debtor to rectify the situation by making payments. Moreover, if periodic monitoring reveals further deficiencies in the level of collateral, the creditor might demand further payments to correct this. Is this the correct course of action in anticipation of a possible bankruptcy? Consider the following illustration:

CASE 17. S loaned money to D secured by a floating lien in D’s inventory. The security agreement required a collateral-to-debt ratio of

\textsuperscript{308} Such a readjustment would make the “debt secured” language of § 547(c)(5) consistent with the way in which an allowed secured claim is determined under § 506 of the Bankruptcy Reform Act of 1978.

\textsuperscript{309} When inventory is the collateral, the debtor’s proper course would be to replace inventory or place the proceeds in a separate deposit account. The creditor has a security interest in these proceeds. Similarly, in order to maintain the level of collateral, the account proceeds should be segregated. The creditor can release the security interest in these funds in return for payment and qualify for § 547(c)(1) protection in any subsequent bankruptcy. See supra note 232.
5:4. On January 1, however, D owed $100,000 but only had $80,000 in inventory. S discovered this on January 15 and demanded $36,000 in payments under threat of default and repossession of all inventory. Struggling to avoid triggering a bankruptcy, D paid the $36,000 to restore the collateral-to-debt ratio. Moreover, S began to institute more frequent checks on collateral. Each subsequent check revealed a further reduction in collateral. In each instance S demanded and received payments. D made payments of $4000, $2000, $6000 and $4000. In the last days before bankruptcy, D sold $12,000 in inventory, but made no payments to S. On April 17, a bankruptcy petition was filed. At that time, D apparently owed S $48,000 and had $48,000 in collateral. D acquired no inventory during the critical period.

Can the trustee avoid any of these payments? During the critical period, S received $52,000, which the trustee should be able to avoid. The payments comprising the $52,000 enable the creditor to “receive more” within the meaning of section 547(b). Without the payments, S would have realized $48,000 in collateral against a claim of $100,000, leaving $52,000 unsecured. With the payments, S is fully secured; he will realize $48,000 in collateral as security for his $48,000 claim. In addition, he has $52,000 in cash. None of the payments, measured on the date of bankruptcy, was secured and they may all be avoided.310

The creditor might try to argue that due to section 547(c)(5), only $20,000 should be avoided. He could argue that on January 1, the gap was $20,000 ($100,000 - $80,000). On the date of the petition, the gap had been narrowed to zero. Section 547(c)(5), however, only protects transfers of collateral, not payments.311 In Case 17, no collateral trans-

310. Since the collateral will be applied against the existing claim of the creditor, payments already made should first be applied against the unsecured portion of the loan. See In re McCormick, 5 Bankr. 726 (Bankr. N.D. Ohio 1980), and cases cited supra at note 268. Since the creditor entered the critical period undersecured, all payments will enable him to receive more regardless of the final state of collateral. If the level of collateral had risen to make available “surplus” collateral, theoretically securing any preferences which were returned, those collateral acquisitions would be preferential. In other words, his oversecured position, upon which he bases his claim that payments were not preferential, is preference-built.

For example, suppose S entered the critical period owing $100,000 secured by $50,000 in inventory. During the critical period, D raised the level of collateral to $100,000 and also paid S $50,000. S might argue that the payments were not preferential because they don’t enable him to receive more. He would argue that if the $50,000 in payments are avoided, he will merely acquire the right to an additional $50,000 in collateral. This argument would be specious. If the payments were avoided, the debt would be $100,000. The acquisition of collateral has reduced the gap from $50,000 to zero. The trustee will also avoid $50,000 in collateral transfers, and S will be unsecured for $50,000.

311. See supra text accompanying note 306 (discussion of Case 15).
fers occurred during the critical period. Section 547(c)(5), therefore, could not protect any of these transfers.

An alternative course of action exists that will better protect a secured creditor if a troubled debtor goes bankrupt. Section 547(c)(5) suggests that the creditor seek a restoration of collateral. If \( S \) had forced \( D \) to restore and maintain the collateral-to-debt ratio by acquisition of additional collateral, he would be in a better position. Had \( D \) nevertheless filed a petition on April 1, \( S \) would have been unsecured for only $20,000. In other words, the trustee would have avoided these transfers of collateral only to the point beyond which the section 547(c)(5) gap was restored to its January 1 level. If \( D \) avoided bankruptcy for ninety days after the collateral was restored, \( S \) would be wholly protected as long as he made sure the level of collateral remained adequate at all times.\(^{312}\)

2. The “Prejudice” Requirement in Section 547(c)(5)

Perhaps the most difficult limitation of section 547(c)(5) is the requirement that any reduction in the gap caused by collateral transfers also be “to the prejudice of other creditors holding unsecured claims.” The history of this limitation makes absolutely clear that the drafters were trying to protect secured creditors in two situations: when collateral fluctuated in value after acquisition and when the debtor expended funds to ready collateral for sale.\(^{313}\)

\(^{312}\) If \( S \) wished to allow \( D \) to operate with somewhat less inventory, he could arrange for a release of security in exchange for a payment. This transaction would qualify for § 547(c)(1) protection. If \( S \) really could not trust \( D \) to maintain the level of collateral, he would be faced with either accelerating the loan and repossessing collateral or instituting a radically stringent policing method. For example, \( S \) might institute a trust receipts or warehousing system by which \( D \) could only sell collateral by agreeing to forward the proceeds to \( S \) in exchange for a release. Then \( S \) would arrange to make new loans to enable the purchase of additional collateral. The payments and releases would qualify for § 547(c)(1) protection. The acquisitions of collateral and new loans would qualify for protection under sections 547(c)(3), (c)(4), or (c)(5). See supra note 232.

\(^{313}\) The limitation was prompted by a letter by Professor Kripke to the Gilmore Committee. Apparently, Professor Kripke noted that certain increases in value of collateral could cause an improvement of position and would not be protected by the receivables and inventory exception. See Commission Report (pt. 1), supra note 8, at 209-10 (partial summary and excerpt of Kripke letter to Gilmore Committee, September 17, 1970). There was some confusion in the Commission Report about the meaning of the Kripke letter. In Note 17 to the preference section, the Commission arguably implied that increases in value because of “e.g., harvesting crops, completing work in progress, sales of inventory, and seasonal fluctuations in value” would cause improvement without any expense to the estate. Commission Report (pt. 2), supra note 8, at 172. This is probably not what the Commission intended because the portion of the Kripke letter quoted in part I of the report explicitly refers to the problem in the work-in-process context. Kripke indi-
In the first instance, a secured creditor might acquire new inventory to replace sold inventory. After the debtor acquired the inventory, it might appreciate in value. Under section 547(b), the transfer of collateral would be preferential and the trustee could avoid the security interest entirely. Under section 547(c)(5), the security transfer would be protected, but only to the extent that the subsection (c)(5) gap was not reduced. If the collateral had appreciated, the gap might be reduced, but without additional resources of the estate being utilized. Congress could have decided to allow the unsecured creditors to enjoy this windfall. Instead they chose to leave the benefit of this appreciation with the secured party.

The situation in which the prejudice requirement protects the creditor should be distinguished from situations in which the creditor is not protected because the gap is narrowed with "prejudice." Compare the following illustrations:

CASE 18. On January 1, D owed S $200,000 secured by a floating lien in D's widget inventory. Other circumstances, unrelated to widget sales, had caused D great financial difficulty. On January 1, D owned 10,000 widgets with a wholesale value of $10 each. During January, D sold $20,000 of these widgets. D had a contract with its supplier, Ace Widget, to receive delivery of 2000 ten-dollar widgets every forty-five days unless D gave notice by the thirty-fifth day. On February 10, Ace assembled and shipped 2000 widgets to D. They arrived on February 12. At that time, Ace notified D, as specified in the contract, that the per widget price would be $12 effective on the next shipment. Costs and market conditions had pushed up the price. D scraped up the money to make a regular timely payment for the February 10 shipment. D immediately notified Ace, however, that it would not require the next scheduled widget delivery. D's financial difficulties resulted in a virtual shutdown of all its operati

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According to Professor Riesenfeld, the original language of § 4-607(d) in the Commission Bill, "at the expense of the estate," was abandoned and the final language, "to the prejudice of other creditors" substituted, at his suggestion, in order to "clear the legislative history" of any misconceptions created by Note 17. The final language itself added nothing. Since many language changes were made from the early draft to the final text, often without explanation, the change itself would not have cleared the legislative history. Professor Riesenfeld, and others, however, have helped make an adequate record of the true application of the prejudice limitation. S. RIESENFELD, CREDITORS' REMEDIES AND DEBTORS' PROTECTION 658 (3d ed. 1979).
ations shortly thereafter. No widgets were sold after January. On April 1, when the bankruptcy petition was filed, D owned 10,000 widgets worth $12 each. During the critical period D made no payments to S.

CASE 19. Assume the status of D and S on January 1 is the same as in Case 18 above. During January and February, however, D sold 5000 widgets and acquired none. On March 2, D acquired and paid for 5000 widgets at $12 each. Unfortunately, 3 days later, the actions of other creditors virtually stopped D's activities. On April 1, a bankruptcy petition was filed. At that time D owned 10,000 widgets worth $12 each, and still owed S $200,000, having made no payments during the critical period.

What can the trustee avoid in each case? In Case 18, security interests in 2000 widgets were the result of preferential transfers under section 547(b). Since the transfers were security interests in inventory, however, section 547(c)(5) applies. The gap on January 1 was $100,000 ($200,000 - $100,000). At the time of bankruptcy it had narrowed to $80,000 ($200,000 - $120,000). Although the gap had been reduced by $20,000, the trustee cannot avoid any collateral transfers. Most of the gap reduction was not caused by collateral transfers, but by an appreciation of collateral acquired before the critical period. This appreciation was not the result of any transfer under section 547(b). Even the portion of the gap reduced by the appreciation of collateral transfers preferential under section 547(b) was not to the prejudice of the unsecured creditors. The gain caused by this appreciation seems to be protected under section 547(c)(5) despite a proportionate reduction in the subsection (c)(5) gap. The legislative history of section 547(c)(5) makes clear that reductions in the gap caused by collateral appreciation unassociated with debtor expense should not result in the loss of subsection (c)(5) protection.314

314. For example, a spokesman for the National Bankruptcy Conference, testifying about the Note 17 confusion, emphasized that the secured creditor should benefit from “an increase in value resulting from inflation or other factors inherent in the product itself.” 1976 House Hearings, supra note 43, at 1842 (statement of Mr. Forman). At the same time, the Conference took pains to point out that appreciation could be accompanied by hidden expenses to the bankrupt which were not to be ignored. For example, the sale of collateral might increase the value of security in as much as the proceeds of sale would be greater than the value of goods in the hands of the debtor. At the same time, there might be expenses of sale. In Mr. Forman’s statement, he indicated that both “direct labor and a suitable portion of overhead charge involved in keeping the enterprise going” would be “prejudicial” costs. Id. The Conference indicated that even seasonal fluctuations can involve some expense to the estate properly allocable to preserving and storing of goods. NBC Bankruptcy Act of 1975, supra note 60, at 364.

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The application of this limitation is further clarified by comparing the result in Case 18 to the result in Case 19. In the latter case the section 547(c)(5) gap had been reduced by $20,000 from $100,000 ($200,000 - $100,000) to $80,000 ($200,000 - $120,000). Appreciation of widgets acquired before the critical period caused $10,000 of this reduction. The debtor, however, paid $60,000 to replace widgets that had originally cost $50,000. Those preferential transfers, the acquisition of 5000 $12 widgets, caused $10,000 of the reduction of the gap. This $10,000 expenditure came from funds which would have otherwise been available to the unsecured creditors. Thus, unlike the situation in Case 18, the trustee may avoid $10,000 in collateral transfers.

"Prejudice" within the meaning of section 547(c)(5) can also be found in situations in which the debtor spends money to complete or otherwise ready collateral for sale. The limitation was designed to resolve questions concerning the allocation of costs between the creditor secured by work-in-process, the transferees who are paid to complete or ready the inventory for sale, and the trustee. Operation of the "prejudice" qualification in section 547(c)(5) suggests another problem relating to the proper integration of sections 547(c)(5) and 547(b). Goods which are completed or otherwise readied for sale normally increase in value. This increase, however, will often exceed the costs associated with completion or sale. The debtor might pay production employees and the utility company $10,000 and these production costs might yield a $15,000 increase in the value of work in process.

Applying section 547(b) only, the direct transfers to the employees and the utility company would be preferential. Again applying section 547(b) only, the transfers would also be "for the benefit" of the inventory financer and thus recoverable from him by the trustee. The direct transferees, the employees and the utility company, may be protected against a trustee recovery by section 547(c)(1) or section 547(c)(2). Does section 547(c)(5) provide a measure of protection for the indirect transferee, the inventory financer? The trustee may argue that section 547(c)(5) has no application because the transfers were payments "for the benefit" of the inventory financer, and not collateral transfers. Section 547(c)(5) would then provide no protection because it applies only to transfers of security interests and not to payment transfers which are indirectly beneficial due to the fact that they increase the value of existing security. The legislative history, however, suggests that at least for section 547(c)(5) purposes, this argument should be rejected.
As the early discussions of H.R. 6 suggest, production expenses related to section 547(c)(5) collateral should be viewed as "transfers" of "security interests." Accordingly, production expense "transfers" seem to be eligible for the limited protection of section 547(c)(5). When these "transfers" are viewed as transfers of security, however, the amount of the preference is uncertain. Neither section 547(b) nor section 547(c)(5) makes clear whether the initially voidable transfer is measured by the amount transferred to procure the improvement (cost) or the resulting benefit from improvement (the increased value of the inventory).

Considering the effect of section 547(b) alone, if the "transfer" of a "security interest" is preferential, it ought to be recoverable in its appreciated state. The structure of section 547(c)(5) further suggests that transfers resulting from the debtor's payment of production expenses are measured by the resulting increase in the value of the security. In referring to the gap reduction calculus, section 547(c)(5) requires a two point comparison of the "value of all security interests." The section is technically silent and arguably neutral on whether each discrete transfer is to be valued at cost or at the resulting increase in value. If the transfers of security in the form of production expenses are valued at cost, however, the prejudice language in section 547(c)(5) becomes irrelevant to the work-in-process case. Moreover, this valuation is inconsistent with the notion contained in section 547(b) that the trustee

315. It is clear from the Kripke letter and the Commission response, incorporated in substance in § 547(c)(5), that the increase in value because of completion, harvesting or sale were to be treated as transfers of security, generally protected by § 547(c)(5) subject to its limitations. If these were not treated as security transfers, but as indirect payments which were § 547(b) preferences, § 547(c)(5) would not protect them at all, even if the § 547(c)(5) gap were not reduced. By treating the increases as security transfers to the secured creditor, at most the "prejudicial" costs to the bankrupt for finishing the goods can be avoided. If other goods had been sold and the proceeds were no longer available, however, the trustee might not be able to avoid these transfers even to that extent. The creditor would be protected except to the extent that the § 547(c)(5) gap was reduced to the prejudice of the unsecured creditors.

Treating these as security transfers also helps to avoid certain problems with the § 547(b) definition. For example, in determining if the indirect transfer to the secured creditor is a preference, which debt should be used to measure antecedence, the debt of the direct transferee or the secured creditor? If the transfer is considered a security transfer when the secured creditor is being considered, the latter is obviously the correct choice. Moreover, should the secured creditor have the benefit of the direct transferee's § 547(c)(2) defense to avoidance? If the allocation explicitly made by § 547(c)(5) is to be followed, the answer is no. Improvement in collateral as a result of unavoidable payments by the bankrupt is the precise problem at which the prejudice limitation of § 547(c)(5) is directed. If the transfer is treated as a security transfer, it is clearer that § 547(c)(2) does not apply, since § 547(c)(2) is directed at payments.
avoids preferential transfers of collateral in the collateral's fully appre-
ciated state.

The concept of prejudice was apparently included in section 547(c)(5) to prevent an unfair denial of protection when the gap is re-
duced at no cost or at a cost less than the reduction. The architects of 
section 547(c)(5) seemed to assume that these production expenses were 
"security transfers," and that a prejudice requirement was essential to 
the gap reduction formula because the resulting "security transfer" 
would often exceed in value the production costs incurred by the 
debtor.\footnote{See supra notes 313 & 315.} Viewing these production expenses as transfers of a "security interest" works well in the common work-in-process case where ex-
isting section 547(c)(5) collateral is improved during the critical period.

However appropriate for section 547(c)(5) purposes, this view of the 
transfer as security seems less appropriate when section 547(c)(5) is not 
at issue. If existing equipment increases in value because of repair, rest-
oration or retooling paid for during the critical period, are the ex-
penses viewed as transfers of security? Can the trustee recover only the 
cost of repair or can he recover the increase in value of the machine? 
Consider the following illustration:

CASE 20. \(D\) manufactured duck decoys. On January 1, \(D\) owed \(SI\) 
$100,000 on an outstanding loan secured by a perfected interest in the 
decoys at all stages of production. The value of \(D\)'s decoy inventory was 
$50,000. Also on January 1, \(D\) owed \(SE\) $100,000 on an outstanding loan. 
\(SE\)'s loan was secured by an interest in all of \(D\)'s woodworking equip-
ment. The equipment was valued at $50,000 on January 1.

Between January 1 and March 1, \(D\) turned blocks of wood into decoys. 
In so doing \(D\) incurred production expenses of $10,000. Solely as a result 
of these expenses, the inventory of \(SI\) increased in value by $20,000. No 
other inventory was "transferred" to \(SI\) during the critical period and \(SI\) 
made no further advances.

Between February 1 and March 1, \(D\) also paid repairmen and techni-
cians $5000 to repair and retool woodworking equipment. These ex-
penses increased the value of \(SE\)'s equipment collateral by $10,000. A 
bankruptcy petition was filed on April 1.

What amount can the trustee recover from \(SI\)? From \(SE\)? When the 
production expenses are viewed as transfers of "security interests" the 
entire increased value of the inventory appears to be vulnerable under 
section 547(b). The creditor is not unfairly treated, however, when the
collateral is inventory. When the collateral is covered by section 547(c)(5) the transfers are protected to the extent that reductions in the section 547(c)(5) gap do not prejudice other creditors.\footnote{Inventory as defined in § 547(a)(1) includes "raw materials and work in process, or materials used or consumed". See supra note 301.} Other creditors could never be prejudiced beyond the production costs. Section 547(c)(5) provides the correct answer regardless of how the transfer is characterized. The initial $50,000 gap ($100,000-$50,000) was reduced by $20,000 to $30,000 ($100,000-$70,000). Only $10,000 of this $20,000 reduction, however, was "to the prejudice of other creditors." Therefore, only $10,000 is recoverable from SE.

Although it is appropriate to treat production expenses as transfers of "security interests" when section 547(c)(5) can be applied, it may not be appropriate to do so when the collateral is not covered by this exception. The transfer to repairmen for the benefit of SE is not protected by section 547(c). Therefore, the only appropriate question is: how much is vulnerable under section 547(b)? Since section 547(c)(5) appears to turn on the assumption that improvements in inventory are transfers of security interests, the same assumption might arguably hold for equipment as well. Under this view, the entire increase in value of the machines would be vulnerable under section 547(b). It would be unfortunate, however, if this assumption were applied to a case outside the scope of section 547(c)(5). Apparently the drafters never explicitly addressed the measurement of these indirect transfers which improve the value of collateral not covered by section 547(c)(5).

As already noted, production expenses might ordinarily be viewed as indirect payment transfers. Because section 547(c)(5) only protects transfer of security interests, the treatment of these transfers as security transfers under subsection (c)(5) was aimed at assuring that these transfers would be eligible for the qualified protection of subsection (c)(5). Any undesirable implications from this assumption are easily checked by the "prejudice" requirement in section 547(c)(5). Since this artificial characterization was designed to bring production expenses within the protection of section 547(c)(5), there is no reason to extend the characterization when subsection (c)(5) is not applicable. When equipment is repaired or improved, this transfer, which benefits a secured creditor such as SE in Case 20, should not be viewed as the transfer of a security interest. It might be better viewed as a payment "for the benefit" of
the secured party (SE) and recoverable only as such. In Case 20, the trustee ought not be able to recover more than $5000 from SE. The trustee should not be able to recover $10,000 by characterizing the transfer as the transfer of a security interest recoverable in its appreciated state.

The integration of sections 547(b) and 547(c)(5) consistently yields the proper result when inventory is improved. It does not matter whether the inventory improved in the production process during the critical period was acquired before or during the critical period. Suppose in Case 20 the debtor had acquired new wood blocks during the critical period and improved them in the production process. The new block acquisitions will clearly be transfers of "security interests" initially vulnerable under section 547(b) but saved by section 547(c)(5) to the extent that no prejudicial gap reduction resulted. Any reduction would be prejudicial only to the extent of actual inventory acquisition costs or production costs expended to complete the decoys. The balance of the added value, if any, is protected as a benefit to the secured creditor resulting from the inherently greater value of completed goods. In contrast, if new equipment was acquired during the critical period and improved by the debtor's expenditures before bankruptcy, the trustee can avoid under section 547(b) the entire security interest in the transferred machine. Here, unlike the case of repair to a machine owned at the beginning of the critical period, the transfer must be treated as the transfer of a security interest and thus recoverable in its appreciated state, even in the rare case where the cost of repair is much less than the resulting increase in value.

The concept of prejudice in section 547(c)(5) raises another integration problem affecting only inventory and receivables. The determination of whether production costs involve prejudice might be affected by whether the production costs were payments to third parties which the trustee may avoid. The solutions discussed in Case 20 assume that the payments to employees and utilities which were the components of these production costs were not recoverable from the direct and primary transferees because of section 547(c)(1) or (c)(2). If the trustee can recapture these payments from the direct transferees, is there any prejudice under section 547(c)(5)? If not, then any gap reduction caused by the resulting increase in value is not recoverable from the secured party, not even to the extent of the production costs. The concept of prejudice requires a net loss to the estate and if the payments to
the direct transferees have been avoided, there is no such loss. The trustee should only have one recovery.318

The separation of prejudicial and nonprejudicial increases in value may often be difficult. Once again, the proper allocation of the burden of proof is essential to the preference scheme. The burden will be on the creditor to establish lack of prejudicial effect.319 When there is an indication of prejudicial effect and the creditor does not present sufficient evidence to make an allocation, he will lose the protection of the limitation.

VI. WORKING WITH THE NEW INTEGRATION IN THE CONTEXT OF COMMERCIAL FINANCING: SOME COMPLEX EXAMPLES

While new section 547 provides a solid conceptual foundation for handling preferences generally, it is not easily applied to the many interrelated transfers incident to a typical financing arrangement. In this regard, Congress gave little attention to the relationship between the various section 547(c) exceptions. In fact, the more visible legislative history seems to assume that the section 547(c) exceptions operate independently of each other.320 There are also conceptual problems with integrating section 547(b), in particular subsection (b)(5), with the separate section 547(c) exceptions. These problems are solved, however, by applying the provisions of sections 547(b) and 547(c) in simple mechanical steps.321

In typical after-acquired property financing arrangements, matters are further complicated. If activity during the critical period merely involved acquisitions and sales of inventory or generation and liquidation of receivables, a simple two-point comparison of the section 547(c)(5) gap would suffice. The calculations might be further complicated by evidence that reductions in the gap were not "prejudicial" to unsecured creditors. Even this problem is really a question of proof.

318. It would seem that the secured creditor, not the other transferees, is better protected by the statute. The other transferees are preferred under the "receives more" test and are protected only by subsections (c)(1) or (c)(2). Of course, employees do have limited § 507 priority which may make some transfers to them nonpreferential under the § 547(b)(5) test. See supra text accompanying notes 145-52. To the extent that the trustee has recovered payments, however, there is no prejudicial effect. Since the § 547(c)(5) exception provides total protection except to the extent indicated, the secured creditor has the advantage.
319. See supra note 76.
320. HOUSE REPORT, supra note 12, at 373; SENATE REPORT, supra note 12, at 88.
321. See supra text accompanying notes 208-23 & 284-319.
and does not overly complicate the preference section. Unfortunately, the difficulties do not stop here.

In many instances, there will be considerable activity between the financing creditor and his debtor. In addition to acquisitions and dispositions of collateral, the critical pre-petition period will include advances by the creditor to the debtor and payments by the debtor to the creditor. Payments might satisfy a portion of the principal of the debt and/or might be applied towards accrued interest. Some payments or transfers of security interests might involve subsection (c)(1) or (c)(3) exceptions. A theory of integrating the subsection (c) exceptions is necessary to properly classify the transactions for section 547 purposes.

The most important and most difficult section 547(c) integration problem is the relationship between subsections (c)(4) and (c)(5). At first glance, integration of these two exceptions seems to involve an irreconcilable circularity problem. In order to compute the section 547(c)(5) gap, the court needs to calculate the "debt secured" on the date of petition. To prevent a double penalty to the creditor, the determination of the "debt secured" figure must reflect the increase in the creditor's claim as a result of the avoidance of preferential payments. The extent to which these payments are avoidable will depend in part on the application of section 547(c)(4). At the same time, section 547(c)(4) protects the creditor from avoidance of preferential payments to the extent of subsequent advances "not secured by an otherwise unavoidable security interest." The circle appears complete when it is noted that whether an advance is "secured" for section 547(c)(4) purposes seems to depend on the extent to which collateral is protected by section 547(c)(5). Once again, the key to breaking the circle is suggested by the statute itself. Moreover, the solution is wholly consistent with the basic purposes and policies of the preference section. Consider the following illustration:

CASE 21. D Corp. was a wholesale distributor of stereo equipment. On January 1, D owed $1,000,000 secured by a floating lien in D's

322. In Case 22, infra text accompanying notes 334-46, payments are applied towards both principal and interest. In many hypothetical cases treated in this Article, the facts assume payments are toward principal and no interest is being earned. This concession to simplicity has not been critical in any problem. As Case 22 demonstrates, a more realistic situation does not pose particularly difficult problems.

323. See supra text accompanying notes 305-08 (discussion of Case 15).

324. See supra text accompanying notes 291-94.
inventory and proceeds, which were worth $800,000. On January 2, \( D \) acquired $200,000 in inventory and paid \( S \) $150,000. On January 15, \( S \) advanced an additional $100,000 to \( D \). On February 1, \( D \) paid \( S \) $50,000. On February 5, \( D \) acquired $100,000 in new inventory. On February 12, \( S \) advanced an additional $60,000 to \( D \). On March 5, \( D \) acquired $150,000 in additional inventory. On March 10, \( S \) advanced an additional $50,000 to \( D \). On March 25, \( D \) paid \( S \) $75,000. On April 1, a bankruptcy petition was filed. Between January 1 and April 1, \( D \) sold inventory valued at $400,000. On April 1, \( D \) had $850,000 in inventory and $50,000 in available proceeds of inventory sold, for a total of $900,000 in collateral.\(^{325}\)

What payments and security interests may the trustee avoid? During the critical period, the debtor has made $275,000 in payments which are section 547(b) preferences. If all of these payments are avoidable, the “debt secured” figure would be adjusted to $1,210,000.\(^{326}\) This would be the maximum “debt secured” figure in the section 547(c)(5) calculation. Based on this adjustment, the section 547(c)(5) gap, which was $200,000 on January 1 ($1,000,000 - $800,000), would be expanded to $310,000 ($1,210,000 - $900,000). \( S \), however, had made $210,000 in advances, some of which will qualify for section 547(c)(4) credit. But how much?

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\(^{325}\) The facts of this hypothetical case are summarized in the following chart. For simplicity’s sake, the hypothetical ignores the effect of accruing interest and unrealistically assumes all payments are applied toward reducing the principal. Case 22 makes more realistic assumptions about payments. The chart also only gives the value of collateral on January 1 and April 1, the dates of the two-point comparison under § 547(c)(5). Intermediate fluctuations are irrelevant; the dates of collateral acquisitions are given in order to show the maximum in transfers of security which would be vulnerable without § 547(c)(5).

<table>
<thead>
<tr>
<th>Date</th>
<th>Inventory Acquisitions</th>
<th>Value of Collateral</th>
<th>Payments to ( S )</th>
<th>Advances to ( D )</th>
<th>Balance on ( D )’s Books</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/1</td>
<td></td>
<td>800,000</td>
<td></td>
<td></td>
<td>1,000,000</td>
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<td>1/2</td>
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<td>150,000</td>
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<td>850,000</td>
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<td></td>
<td>850,000</td>
</tr>
<tr>
<td>1/15</td>
<td></td>
<td></td>
<td>100,000</td>
<td></td>
<td>950,000</td>
</tr>
<tr>
<td>2/1</td>
<td></td>
<td></td>
<td>50,000</td>
<td></td>
<td>900,000</td>
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<tr>
<td>2/5</td>
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<td></td>
<td>900,000</td>
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<tr>
<td>2/12</td>
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<td>60,000</td>
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<td></td>
<td></td>
<td>935,000</td>
</tr>
<tr>
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<td></td>
<td>900,000</td>
<td></td>
<td></td>
<td>935,000</td>
</tr>
</tbody>
</table>

\(^{326}\) This upward adjustment is made to prevent a double recovery by the trustee. See supra text accompanying notes 305-08 (discussion of Case 15).
First, no more than $200,000 in advances can qualify. The January 15 advance of $100,000 can save part of the January 2 preferential payment of $150,000. The $60,000 advance of February 12 can protect all of the $50,000 payment of February 1 and $10,000 of the yet unprotected portion ($50,000) of the January 2 preferential payment. The $50,000 advance on March 10, however, can only protect the yet unprotected prior payments—$40,000 from the January 2 preferential payment. Section 547(c)(4) does not protect any of the subsequent payments on March 25. At minimum, the trustee can avoid that $75,000 March 25 preferential payment. We can, therefore, preliminarily compute the trustee’s minimum payment recovery and the minimum “debt secured” figure for section 547(c)(5) purposes.\(^{327}\)

The minimum payment recovery and the minimum “debt secured” figure provide an important preliminary calculation for section 547(c)(5) purposes. In Case 21, the minimum section 547(c)(5) “debt secured” after adjusting the debt for the minimum payment recovery of $75,000 is $1,010,000 ($935,000 balance on D’s books plus $75,000). With $900,000 in collateral, the subsection (c)(5) gap would be reduced from $200,000 to $110,000 ($1,010,000-$900,000). Thus the trustee could avoid $90,000 in security interests, the maximum collateral avoidance, if all $200,000 of possible subsection (c)(4) credit was “unsecured.” By the same token, the creditor, S, under this preliminary calculation, would only be entitled to keep $810,000 in collateral, the minimum available collateral.

For each dollar of the possible $200,000 subsection (c)(4) credit which is disqualified, the trustee will be able to avoid an additional dollar in payments, and the section 547(c)(5) “debt secured” figure will be adjusted one dollar upwards.\(^{328}\) This in turn will protect one additional dollar in collateral by permitting the creditor to keep it without narrowing the gap. In Case 21, $90,000 worth of collateral is available to be “picked up” as a result of any upward adjustment of the section 547(c)(5) “debt secured” figure. Therefore, if $90,000 of the possible subsection (c)(4) credit is disqualified, S will keep $90,000 in additional collateral. The disqualification of this possible subsection (c)(4) credit

\(^{327}\) The minimum payment recovery is the amount of preferential payments which, regardless of security, does not qualify for § 547(c)(4) credit. The minimum “debt secured” figure for § 547(c)(5) purposes is the debt adjusted upwards for those payments which will certainly be avoided, the minimum payment recovery.

\(^{328}\) See supra text accompanying notes 305-08 (discussion of Case 15).
validates otherwise avoidable security interests. In other words, the possible subsection (c)(4) credit should be considered as “secured by an unavoidable security interest” to the extent that collateral which would otherwise be unprotected under section 547(c)(5) can be protected.\(^{329}\) This collateral becomes protected when the possible subsection (c)(4) credit is disqualified resulting in more payment avoidance and a larger “debt secured.”\(^{330}\) The remaining credit, $110,000 in Case 21, is both unsecured and subsequent to preferential payments. Only to this extent does section 547(c)(4) make advances available as a set-off against otherwise avoidable payments. The remaining $165,000 in payments can be avoided. When this $165,000 is added to the final “debt secured” figure, however, the trustee will not be able to avoid any security interests.\(^{331}\)

This method of integrating sections 547(c)(4) and 547(c)(5) is not only consistent with the language of the statute, but is consistent with the entire preference scheme. The trustee’s burden is eased by facilitating avoidance of the maximum amount in payments and protecting in return the maximum in collateral.\(^{332}\) The costs and risks of actually realizing the value of collateral are placed on the party who bargained for the collateral as security, not on the trustee as representative of other creditors.

Only one other refinement of the integration of subsections (c)(4) and (c)(5) is necessary. Possible subsection (c)(4) credit would not qualify to the extent that it is secured by collateral not covered by subsection (c)(5). This credit should be disqualified first, along with advances which are not subsequent to preferential transfers. In Case 21, if the January 15 advance had been secured by an unavoidable security interest in two of D’s delivery trucks, each worth $10,000, only $80,000 would be available under subsection (c)(4). The next two advances, for example, if only $150,000 in § 547(c)(4) credit were available, the trustee could avoid $50,000 in payments, in addition to the $75,000 already certainly avoidable. This would result in the § 547(c)(5) “debt secured” figure being adjusted upwards to $1,060,000. Therefore, the § 547(c)(5) gap would then be $160,000, a reduction of only $40,000. The trustee could avoid $40,000 in collateral transfers, leaving the creditor $860,000 in collateral. The disqualification of $50,000 in § 547(c)(4) credit resulted in protection of an additional $50,000 in collateral.

Any new value should be considered to be secured by an “unavoidable security interest” to the extent that the new value validates under § 547(c)(5) otherwise avoidable security interests. See supra text accompanying Case 14.

After the payments are avoided, the § 547(c)(5) “debt secured” figure on the date of the petition will be $1,100,000. The value of collateral will be $900,000 for a gap of $200,000, the same as on January 1.

See supra text accompanying notes 306-09 (discussion of Case 16).
however, would qualify as possible subsection (c)(4) credit, for a total of $190,000. Of this amount, $90,000 would still be secured by available subsection (c)(5) collateral. Only the remaining $100,000 would qualify under subsection (c)(4) and the trustee could avoid $175,000 in payments, but still no security interests in collateral would be avoidable.333

Once the major integration problems in section 547 are overcome, it becomes relatively easy to deal with any additional levels of complexity incident to commercial financing. The debtor may have made payments toward accrued interest. Collateral may have appreciated in value which may be due only in part to the use of the debtor's resources. The creditor may have released some collateral for bulk sale to allow the debtor to reduce his costs. The debtor may have paid over some or all of the proceeds of collateral to the creditor. None of these or other conceivable complications pose overly difficult problems for the trustee or the court. Consider the following illustration:

CASE 22. D Corporation was engaged in the business of assembling, selling and installing heating systems. Although D manufactured no components, it did purchase other components and combine them into systems of its own design. D Corporation was experiencing extreme financial difficulty because of bad credit decisions and high interest rates. S Bank was a major creditor of D, secured by a floating lien in D's inventory and accounts. On January 1, D owed S $2,000,000 secured by $1,500,000 in inventory and accounts.

On January 15, D paid S $110,000. Of this amount, $10,000 was interest for the first two weeks in January. On February 1, D paid S $109,500, $9,500 of which was accrued interest. On February 15, D made an interest payment of $90,000. On February 21, S loaned D an additional $150,000. On March 1, D paid accrued interest of $9375. At that time, S also gave written permission to D to sell $450,000 in collateral to X Inc. The purpose of this sale was to reduce the level of inventory. D agreed to pay over to S the proceeds of the sale. D made this payment of $450,000 on March 8. On March 15, D paid S $108,625. Of this amount, $8,625 was interest. D paid no further money to S.

On April 1, a bankruptcy petition was filed. The value of inventory,

333. This hypothetical assumes that the transfer of the security interest in equipment was not avoidable. This would occur if the equipment secured only the advance and the security interest were properly perfected within 10 days. The transfer of security would then relate back to the date of the security agreement under § 547(e)(2), and the transfer would not be for antecedent debt. Even if the transfer is for an antecedent debt, it might qualify for protection under § 547(e)(1).
accounts and proceeds on the date of the petition was $1,300,000. This figure is the result of activity not specifically itemized above. This activity included the sale of additional inventory and the liquidation of some accounts. This also included inventory and accounts acquired during the critical period which are still on hand and are worth $750,000. D expended funds assembling heating systems, which increased the value of some of the inventory. Some completed systems were installed and generated the accounts referred to. Uninstalled systems remain as available inventory. Costs such as salaries and utility bills were incurred in order to assemble and install various components. Although these expenditures helped to increase the value of available collateral, the S Bank can prove that $75,000 of this increase is due to factors other than properly allocable costs. Some of these other factors include inflation, market conditions, and the inherent value of completed collateral.

Finally, the creditor's claim includes $7000 in unpaid interest that accrued between March 15 and the filing of the petition. It presently appears from the books, before taking into account preference avoidance, that D owes S $1,407,000.334

What transfers may the trustee avoid? During the critical period, D has made interest and principal payments to S totaling $796,500. All of these payments to an undersecured creditor are preferential under section 547(b).335 S, however, will attempt to assert that some of these

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334. The facts of this hypothetical case are summarized in the following chart. In this instance, payments are divided toward principal and interest. For simplicity's sake, the details of inventory acquisition, completion, sale and installation are ignored. It is important to note, however, that S, the creditor, would bear the burden of proving that any reduction in the § 547(c)(5) gap was not prejudicial. Once again, the chart merely details the value of collateral on January 1 and April 1, the dates of the two-point comparison under § 547(c)(5). The inventory and account acquisitions and other costs are given merely to demonstrate the degree to which S would be vulnerable without § 547(c)(5).

<table>
<thead>
<tr>
<th>Date</th>
<th>Value of Collateral</th>
<th>Payments to S</th>
<th>Payments toward Principal</th>
<th>Advances to D</th>
<th>Balance on D's Books</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/1</td>
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</tr>
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<td>1,300,000</td>
<td></td>
<td></td>
<td></td>
<td>1,407,000</td>
</tr>
</tbody>
</table>

335. S began the critical period undersecured. Although he appears to be oversecured on April 1, this situation was caused by a combination of preferential payments and collateral transfers.
payments are protected by subsections (c)(1) and (c)(4). Moreover, a substantial amount of collateral was acquired within the critical period. Additional resources were expended by D to acquire the inventory, complete it, ready it for sale, and to sell or install it, thereby generating accounts. This acquisition of collateral, as well as expenditures to complete or improve it, were preferential collateral transfers under section 547(b). 336 S, however, will assert that section 547(c)(5) protects these transfers, at least in part.

The first step in resolving this case is to deal with those section 547(c) exceptions for which the date of transfer, not the date of petition is the critical date. 337 S has a strong claim that the March 8 payment of $450,000 is not avoidable by virtue of subsection (c)(1). The release of the collateral, or new value, was intended to be contemporaneous and was in fact substantially contemporaneous. If S successfully proves the elements of subsection (c)(1), only $346,500 in payments remain vulnerable (the sum total of all other payments from D to S).

The parties to the dispute must now deal with the more difficult subsection (c)(4) and subsection (c)(5) integration. S has advanced $150,000 which might qualify as subsection (c)(4) credit. The advance was subsequent to $228,500 in preferential payments. Therefore, the only issue is to what extent the $150,000 advance is “secured” for subsection (c)(4) purposes.

If the entire $150,000 qualifies under subsection (c)(4), $196,500 ($346,500 - $150,000) will still be recovered by the trustee (the minimum payment recovery). The minimum “debt secured” figure for subsection (c)(5) purposes will be $1,603,500 ($1,407,000 + $196,500). Using this amount, the court can make a preliminary determination of how much collateral will be avoided if the entire $150,000 in new credit qualifies

336. The legislative history makes clear that Congress intended to treat expenses of completion as transfers of security under § 547(c)(5), and, therefore, under § 547(b) as well. See supra notes 313 & 315. In Case 22, part of the accounts which came into existence during the critical period would be proceeds of previously existing inventory. Part would also be generated by expenditures made on that inventory, including sale, completion and installation. Case 22 merely suggests substantial acquisitions and sales of inventory and generation and liquidation of accounts. Because the collateral transfers incident to these events are all covered by § 547(c)(5), it is unnecessary for the facts to indicate the precise extent of § 547(b) preferential transfers.

337. The exceptions in § 547(c)(1), § 547(c)(2) and § 547(c)(3) fit in this category. See supra text accompanying notes 237-83. The § 547(c)(5) exception obviously depends on the situation on the date of the petition. In order to determine the extent that new value advances are secured or unsecured under § 547(c)(4), the situation on the date of the petition must be analyzed.
under subsection (c)(4).\textsuperscript{338}

On January 1, ninety days before the petition, the subsection (c)(5) gap was $500,000. If all $150,000 in credit qualifies, the minimum “debt secured” figure will be $1,603,500. The value of collateral on April 1 was $1,300,000, for a gap of $303,500. The subsection (c)(5) gap has been apparently reduced by $196,500.\textsuperscript{339} Not all of this reduction however, is necessarily avoidable. The prejudice limitation of subsection (c)(5) must still be figured into the calculation.

The purpose of establishing the effect of the prejudice limitation is clear if the next step is kept in mind.\textsuperscript{340} At this preliminary stage, the court should establish the maximum collateral avoidance, that is, how much collateral is not protected by subsection (c)(5) if subsection (c)(4) protects $150,000 in preferential payments. The court can then determine the extent to which additional collateral will become protected if the subsection (c)(5) “debt secured” figure is further increased if additional payments are unprotected. Additional payments will be unprotected if some of the $150,000 does not qualify as credit under subsection (c)(4). To the extent that additional collateral is made available to the creditor, possible section 547(c)(4) advances are “otherwise secured.”\textsuperscript{341} The first step is a preliminary section 547(c)(5) calculation to determine how much collateral will be avoided if all of the possible subsection (c)(4) credit can be used to reduce the otherwise recoverable payments.\textsuperscript{342} This preliminary calculation will be accurate only if all of the subsection (c)(5) qualifications are taken into account. To the extent that any reduction in the gap is not prejudicial, the trustee cannot avoid it. Therefore, in calculating an accurate maximum collateral avoidance, it is necessary to subtract any nonprejudicial reduction in the gap.

In Case 22, $S$ can apparently prove that $75,000 of the reduction in the subsection (c)(5) gap was not prejudicial. Therefore, even if all $150,000 qualifies under subsection (c)(4), only $121,500 of the $196,500 reduction in the subsection (c)(5) gap may be avoided. If, however, the trustee can avoid an additional $121,500 in payments, $S$

\begin{itemize}
  \item \textsuperscript{338} See supra text accompanying notes 328-32.
  \item \textsuperscript{339} The original gap of $500,000 ($2,000,000 - $1,500,000) has been reduced to $303,500 ($1,603,500 - $1,300,000), a reduction of $196,500.
  \item \textsuperscript{340} See supra text accompanying notes 313-19.
  \item \textsuperscript{341} See supra text accompanying notes 328-32.
  \item \textsuperscript{342} See supra text accompanying notes 327-28.
\end{itemize}
will be able to recover an additional $121,500 in collateral under subsection (c)(5). Therefore, this amount is otherwise "secured" for subsection (c)(4) purposes and only $28,500 qualifies for set-off under subsection (c)(4). 343

To summarize, the trustee may not avoid the March 8 payment of $450,000. Of the remaining $346,500 in payments preferential under section 547(b), $28,500 is protected by subsection (c)(4) set-offs and $318,000 is avoidable. For subsection (c)(5) purposes, the "debt secured" figure is adjusted upwards, reflecting the preference recovery of $318,000, for a final "debt secured" figure of $1,725,000. The value of collateral is $1,300,000 and the subsection (c)(5) gap has been reduced by $75,000. S, however, can prove this reduction was nonprejudicial and therefore no security interests are avoidable.

No special calculations were required in order to account for the fact that payments were made toward both interest and principal. Certainly the distinction has no effect on whether the payments were preferential. 344 For subsection (c)(5) purposes, there is also no need for a distinction. The typical security agreement will almost certainly provide that the collateral secures both principal and interest. The section 506 definition of a "secured claim" is based on the assumption that these provisions are in the security agreement. 345 The trustee and court should take care to ensure that the subsection (c)(5) "debt secured" figure at the first point of comparison includes unpaid interest accrued until that date. Therefore, at both points in the subsection (c)(5) comparison, the "debt secured" figure will be consistent with the section 506 definition of a "secured claim." To the extent that accrued interest remains unpaid or any interest payments are avoided, they are included in the readjusted subsection (c)(5) "debt secured" figure on the date of the petition. 346

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343. See supra text accompanying notes 328-32.

344. The payments are either "for or on account of an antecedent debt." The creditor cannot attempt to argue that the interest payments qualify for § 547(c)(2) protection. See supra note 268 and cases cited therein.

345. 11 U.S.C. § 506(b) (Supp. V 1981) provides:

To the extent that an allowed secured claim is secured by property the value of which, after any recovery under subsection (e) of this section, is greater than the amount of such claim, there shall be allowed to the holder of such claim, interest on such claim, and any reasonable fees, costs, or charges provided under the agreement under which such claim arose.

346. The creditor cannot successfully classify unpaid interest as new value advances under § 547(c)(4), even if he refinances the debt. If the creditor lends additional money to the debtor to
VII. CONCLUSION

The new section 547 integration does not make the application of preference law to commercial financing simple. If, however, the integration is applied in the proper sequence of small steps it yields a more mechanical, predictable result—a result fairer to all creditors.

The first step is the proper application of section 547(b). The integration of definition and exception requires a strict, literal application of section 547(b). The individual elements in the definition, the “antecedent debt” and “receives more” requirements in particular, must be relieved of much of the case law baggage they carried under section 60. The second step is the proper ordering of definition and exception. The status of each transfer must be separately and preliminarily determined under section 547(b)(5) before their combined impact is judged and before the exceptions in section 547(c) are applied. The third step is the proper integration of the various exceptions. Both individual collateral transfers and payments to a secured creditor may be protected under more than one exception. When the creditor has a choice of exceptions applicable to the same type of transfer, those exceptions which require an evaluation at the time of transfer should be applied first. When the combined effect of two or more types of transfer is critical to the operation of the exceptions, as it is when sections 547(c)(4) and 547(c)(5) are applied to payments and collateral transfers, a preliminary calculus is required. Once again the steps involved in the computation are straightforward.

This relationship between the preference definition and the section 547(c) exceptions, and among the various exceptions, has been derived from the structure of the statute and its drafting history. The mechanics essential to the application of the section were in turn derived from these relationships. Perhaps both the underlying relationships and the mechanics should have been more explicitly detailed in the statute. In this sense, section 547 is flawed. The unrealistically tight time limits in section 547(c)(2) may be a further flaw. These problems, however, do not justify changes which are inconsistent with the goals of the new preference scheme.

The legislative design is basically sound. Hastily conceived and drastic changes, such as the proposed reintroduction of the requirement pay off accrued interest, this money will not qualify as new value under § 547(a)(2). The definition of new value “does not include an obligation substituted for an existing obligation.”
that the creditor "have reasonable cause to believe," go too far. They undermine the mechanical efficiency of the new definition and displace many of the carefully crafted limitations in the section 547(c) exceptions. These drastic changes would be unwise, at least at this time. Some adjustment of the section 547(c) exceptions may be justified, such as minor changes in subsection (c)(2). Even these changes, however, should be cautiously considered so that the basic equality principle does not give way to the special interests of particular creditors.

The new integration needs time—time in the courts to sort itself out from the obsolete concepts born under section 60 and time to allow the development of a new preference jurisprudence. Then, and only then, will the fairness and efficiency of new preference section be proved or disproved.