New Value and Preference Avoidance in Bankruptcy

Thomas J. Palazzolo
NEW VALUE AND PREFERENCE AVOIDANCE IN BANKRUPTCY

INTRODUCTION

A debtor repays a debt to a creditor. Soon thereafter, the debtor files bankruptcy.¹ The court then forces the creditor to return the payment to allow the other creditors to share in it.² Although such a result might seem unfair, it is not.³ Bankruptcy law establishes priorities for distribution to creditors,⁴ requiring creditors to line up for payment on the basis of certain defined criteria. A creditor who receives payment on the eve of bankruptcy, however, jumps to the front of the line.⁵

The law of avoidable preferences exists to prevent such line jumping. Under the Bankruptcy Code,⁶ a trustee may bring an action to void certain of the debtor's pre-bankruptcy transfers made to a creditor.⁷ Section 547(b)⁸ of the Bankruptcy Code establishes criteria by which a court determines if a pre-bankruptcy transfer is preferential and therefore voidable. Section 547(c)⁹ of the Bankruptcy Code sets forth seven exceptions to a trustee's power to void preferential transfers.¹⁰ The concept of "new value" plays an integral role in two of the exceptions.¹¹ Section 547(c)(1)¹² excepts from avoidance a transfer offset by a contemporaneous exchange of new value from a creditor. Section 547(c)(4)¹³ excepts

². The hypothetical assumes that the transfer meets the criteria of a voidable preference. See 11 U.S.C. § 547(b) (1988).
³. Although the creditor forced to return the payment might disagree as to the result's fairness, preference law looks toward fairness to the entire group of creditors rather than to one individual creditor. See infra note 20.
⁵. See T. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW 9 (1986) (comparing the priority system for creditors to standing in line at a popular rock concert; those at the front of the line get the best seats, while those at the end may get no seat at all).
¹⁰. See infra notes 40-49 and accompanying text.
from avoidance a transfer offset by a subsequent transfer of new value by a creditor.

Courts have read the Bankruptcy Code's definition of "new value" expansively. This Note argues that such judicial expansions, unsupported by the statutory definition of "new value," tend to undercut the primary bankruptcy objective of facilitating equal distribution of a debtor's assets among creditors.

The Note begins by examining preference law, its history, mechanical operation, and underlying purpose within bankruptcy. Part II looks at the two new value exceptions, and at the way in which the exceptions fit within the overall purposes of bankruptcy. Part III considers whether Congress intended an exclusive statutory definition of new value. Part IV surveys judicial decisions that found new value in a creditor's forbearance of an existing legal remedy, a creditor's failure to perfect a statutory lien, a creditor's release of a letter of credit, and a creditor's granting or honoring of a guarantee. Part V presents an analysis of these judicial decisions. The Note concludes by suggesting that the underlying principle of preference law would be better served by a judicial test for new value that looked to whether the transfer in question depletes the debtor's assets to the detriment of other creditors.

I. PREFERENCES

Bankruptcy law provides a collective forum in which the debtor's re-
remaining assets are distributed among creditors. A major principle of bankruptcy law is that similarly situated creditors must receive an equal distribution of the debtor's assets. A creditor aware of an impending bankruptcy would prefer to receive payment from a debtor prior to the filing of bankruptcy in order to get more money. However, the law of avoidable preferences extends the principle of equality of distribution to a point before the actual bankruptcy. "Preferences" are those transfers, made prior to a filing of bankruptcy, that enable a creditor to receive a greater share of the debtor's assets than the creditor would otherwise receive through a bankruptcy distribution. A preference is subject to recapture and distribution with the remainder of the debtor's property.

Section 547(b) sets forth the elements of a preference. There must be a "transfer of an interest of the debtor in property." The transfer must be made "to or for the benefit of a creditor." It must be "for or on account of an antecedent debt owed by the debtor." The debtor must be "insolvent" at the time of the transfer. The transfer must occur...

20. See T. Jackson, supra note 5, at 7-19 (1986). Creditor remedies outside bankruptcy tend to operate on a first come, first served basis. Id. at 9. These individual remedies may operate detrimentally on creditors as a group when the debtor does not have enough assets to satisfy every claim. Id. at 10. Bankruptcy therefore imposes a compulsory and collective proceeding on creditors that, in effect, restricts individual creditors for the group's benefit. Id. at 12-13. See generally Jackson, Bankruptcy, Non Bankruptcy Entitlements, and the Creditor's Bargain, 91 Yale L.J. 857 (1982).


22. T. Jackson, supra note 5, at 122, 125.


26. 11 U.S.C. § 547(b) (1988). The Code defines "transfer" as "every mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with property or with an interest in property, including retention of title as a security interest and foreclosure of the debtor's equity of redemption." 11 U.S.C. § 101(50) (1988).


within the ninety-day period immediately preceding bankruptcy.31 If the transferee is a statutory "insider,"32 the preference period extends to one year.33 Finally, because of the transfer, the creditor must receive a larger distribution of the debtor's assets than he would receive had the transfer not been made, and were the creditor instead to receive a distribution in a Chapter 7 bankruptcy liquidation.34

Preference avoidance serves two congressionally stated objectives.35 Avoidance facilitates the bankruptcy principle of equality of distribution among a bankrupt's creditors.36 Avoidance also serves to discourage a race to the courthouse by creditors seeking to dismember a debtor during his slide into bankruptcy.37

This presumption shifts the burden of production, but not the burden of proof, from the trustee. See Jahn v. Reading Body Works, Inc. (In re Fassnacht & Sons, Inc.) 45 Bankr. 209 (E.D. Tenn 1984).

34. 11 U.S.C. § 547(b)(5) (1988). A payment to a general unsecured creditor generally will meet the (b)(5) test as long as the general unsecured creditor would not have received full payment for its claim. See Barash v. Public Fin. Corp., 658 F.2d 504, 508-09 (7th Cir. 1981). A payment to a fully secured creditor generally is not a preference because in a Chapter 7 liquidation such a creditor's claim would be paid fully. See 4 COLLIER ON BANKRUPTCY § 547.08, at 43 (15th ed. 1991). Thus, such a payment would not meet the (b)(5) element and no preferential transfer would exist. For a discussion of issues relating to the (b)(5) test, see generally Ward & Shulman, In Defense of the Bankruptcy Code's Radical Integration of the Preference Rules Affecting Commercial Financing, 61 WASH. U.L.Q. 1, 41-51 (1983).
35. The House Committee Report that accompanied Section 547(b) discussed the purposes of preference law:

The purpose of the preference section is two-fold. First, by permitting the trustee to avoid prebankruptcy transfers that occur within a short period before bankruptcy, creditors are discouraged from racing to the courthouse to dismember the debtor during his slide into bankruptcy. The protection thus afforded the debtor often enables him to work his way out of a difficult financial situation through cooperation with all of his creditors. Second, and more important, the preference provisions facilitate the prime bankruptcy policy of equality of distribution among creditors of the debtor. Any creditor that received a greater payment than others of his class is required to disgorge so that all may share equally. The operation of the preference section to deter "the race of diligence" of creditors to dismember the debtor before bankruptcy furthers the second goal of the preference section—that of equality of distribution.


36. Id.

37. Id. The race to the courthouse is the race of individual creditors to take advantage of state law remedies. Id. Some dispute exists over whether and to what extent preference law deters creditor behavior. Compare Jackson, Avoiding Powers in Bankruptcy, 36 STAN. L. REV. 725, 762 n. 111 (1984) (although not a total deterrent, preference law reduces an action's benefit and, thus, reduces the incidence of the behavior) with McCoid, supra note 25, at 264 (a creditor will keep the transfer if
In the past, preference law was concerned with the transferor or transferee's intent. Modern preference law, however, shows no such con-

Although to some degree historically linked, preferences are distinguishable from fraudulent conveyances. See generally UNIF. FRAUDULENT CONVEYANCE ACT, 7A U.L.A. 427 (1918); UNIF. FRAUDULENT TRANSFER ACT, 7A U.L.A. 639 (1984). A fraudulent conveyance is a transfer by a debtor in an attempt to hide assets from all creditors. Jackson, supra, at 778. A preference, on the other hand, merely prefers one creditor to the detriment of other creditors. See 4 COLLIER ON BANKRUPTCY § 547.01, at 14 (15th ed. 1991). See also Van Iderstine v. National Discount Co., 227 U.S. 575, 582 (1913) (in discussing the difference between a fraudulent conveyance and a preference, the Court stated: "One is inherently and always vicious; the other innocent and valid, except when made in violation of the express provisions of a statute. One is malum per se, and the other malum prohibitum").

Preference law has roots in English conceptions of fraud. See McCoid, supra note 25, at 250; Countryman, supra note 16, at 714-18. See also Clark, The Duties of the Corporate Debtor to its Creditors, 90 HARV. L. REV. 505, 513 (1977) (suggesting that the most famous case in fraudulent conveyance law, Twyne's Case, 3 Coke 806, 76 Eng. Rep. 809 (Star Ch. 1601), involved only a preference, rather than a fraudulent conveyance).

English courts began to develop a separate concept of a voidable preference during the latter half of the 16th century. The law of the time provided that, when a debtor committed an "act of bankruptcy," creditors could petition the Chancellor for the appointment of Commissioners to administer the debtor's property for the creditors' benefit. See McCoid, supra note 25, at 250-51. In the Case of Bankrupts, Lord Coke stated in dictum that it would be "unequal and unconscionable" to allow a debtor, after he becomes a bankrupt, to prefer a creditor. 76 Eng. Rep. 441, 473 (K.B. 1584). English courts developed Lord Coke's dictum into a "relation-back" rule. The rule deemed that title to the debtor's property passed to the Commissioners at the time the debtor committed an act of bankruptcy. See McCoid, supra note 25, at 251; Weisberg, supra note 23, at 40-42. Thus, a debtor's transfer after an act of bankruptcy was void. Weisberg, supra note 23, at 41. However, A preferential transfer before an act of bankruptcy was safe. Id. at 43.

Lord Mansfield, in a series of judicial decisions in the mid-18th century, established a more modern basis for the recapture of preferential transfers made before bankruptcy. Id. at 46-51 (citing Worsley v. DeMattos, 96 Eng. Rep. 1160 (K.B. 1758); Alderson v. Temple, 96 Eng. Rep. 384 (K.B. 1768); and Harman v. Fishar, 98 Eng. Rep. 998 (K.B. 1774)). Lord Mansfield distinguished acceptable preferences from void preferences in the following manner: If on the eve of bankruptcy a creditor without fraudulent intent demands a preference, sues the debtor, or threatens the debtor, the preference is good; but, if the debtor makes the distribution with "a positive view of iniquity," the preference is bad. Alderson v. Temple, 96 Eng. Rep. 384, 385 (K.B. 1768) ("If the conveyance be to distribute all his effects just as the Statutes of Bankruptcy direct, it is fraudulent and void; because a man shall not choose his own assignees, and thereby defraud the law, which vests the power over bankrupts in the Great Seal"). Two major currents within preference law developed from Lord Mansfield's judicial decisions. First, a preferential transfer made on the eve of bankruptcy is voidable when a debtor attempts to establish his own scheme of distribution. Second, the court should determine a voidable preference by focusing upon the debtor's intention in making the transfer. See Weisberg, supra note 23, at 46-47. American law, however, no longer focuses upon the debtor's intent. See infra note 39 and accompanying text.

38. See Weisberg, supra note 23, at 4, 39-55; Countryman, supra note 16, at 718-25. During the development of English preference law, courts considered the debtor's culpability and found a preference when the debtor intended his transfer to benefit one creditor over another. See supra note
cern with the creditor or debtor's culpability; a trustee may avoid completely innocent transfers that meet the section 547(b) criteria.\(^\text{39}\)

II. EXCEPTIONS

Not all transfers that meet the objective criteria of section 547(b) are avoidable.\(^\text{40}\) Congress established seven exceptions to the trustee's avoiding power.\(^\text{41}\) A transfer is shielded from avoidance to the extent the transfer qualifies under an exception.\(^\text{42}\) Two of the exceptions require a transfer of new value from the creditor to the debtor.

The section 547(c)(1) exception provides that a trustee may not avoid a

37. *See also* Countryman, *supra* note 16, at 718-20. Although early American preference law retained the English concern over debtor culpability, by the end of the 19th century the focus had shifted from the debtor's intent to that of the creditor. *See* McCoid, *supra* note 25, at 253-59; Weisberg, *supra* note 23, at 112-116. *See also* Bankruptcy Act of July 1, 1898, ch. 541, § 60(b), 30 Stat. 544, 562 (repealed 1978) (creditor must have reasonable cause to believe that the transferor intended to give a preference). Subsequent amendments to the Bankruptcy Act changed the requirement to a showing by the trustee that the creditor had "reasonable cause to believe that the debtor is insolvent" at the time of the transfer. *See* Act of June 22, 1938, ch. 575, § 60(b), 52 Stat. 840, 870 (repealed 1978). This was the state of the law until Congress repealed the Bankruptcy Act in 1978.

39. *See, e.g.,* Barash v. Public Fin. Corp., 658 F.2d 504, 510 (7th Cir. 1981) (creditors' knowledge or state of mind no longer relevant); Countryman, *supra* note 16, at 748 (transfers that distort the policy of equal distribution "do so without regard to the state of mind of either the debtor or the preferred creditor"). *See generally* Weisberg, *supra* note 23, at 117-33.

In the legislative history that accompanies Section 547(b), the House Report discussed the rationale for eliminating any focus on the creditor's state of mind. The House Report began with a discussion of the Bankruptcy Act's preference section.

[T]he trustee must show that the creditor for whose benefit the preferential transfer was made had "reasonable cause to believe the debtor was insolvent at the time of the transfer." This provision was designed when the primary purpose of the preference section was to prevent the race of diligence. Whether or not a creditor knows or believes that his debtor is sliding into bankruptcy is important if the only purpose of the preference section is to deter the race.

However, a creditor's state of mind has nothing whatsoever to do with the policy of equality of distribution, and whether or not he knows of the debtor's insolvency does little to comfort other creditors similarly situated who will receive that much less from the debtor's estate as a result of the prebankruptcy transfer to the preferred creditor. To argue that the creditor's state of mind is an important element of a preference and that creditors should not be required to disgorge what they took in supposed innocence is to ignore the strong bankruptcy policy of equality among creditors. Finally, the requirement that the trustee prove the state of mind of his opponent is nearly insurmountable, and defeats many preference actions.


41. *Id.*


http://openscholarship.wustl.edu/law_lawreview/vol69/iss3/8
transfers intended by both parties to be a contemporaneous exchange for new value, provided that it is, in fact, substantially contemporaneous. Although the legislative history indicates the exception is to apply to transfers by checks, the language of the statute does not limit the exception only to such transactions. The exception's apparent rationale is that the transfer of new value offsets the preference. Thus, the debtor's estate is not depleted to other creditors' detriment.

The section 547(c)(4) exception protects a creditor who makes an advance of new value to the debtor, after the creditor receives a preference. The amount subsequently advanced protects an equivalent amount of the preference from avoidance. The exception's purpose is to encourage creditors to continue to deal with troubled businesses.

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43. The trustee may not avoid under this section a transfer—
   (1) to the extent that such transfer was
      (A) intended by the debtor and the creditor to or for whose benefit such transfer was
          made to be a contemporaneous exchange for new value given to the debtor; and
      (B) in fact a substantially contemporaneous exchange.

44. See H.R. REP., supra note 16, at 373, reprinted in 1978 U.S. CODE CONG. & ADMIN. NEWS 5963, 6329. The House Report states that although a payment by check normally is a credit transaction, payment by check in the normal course of business is protected by the exception. Id. This statement contradicts an official comment by Representative Edwards that, contrary to the language in the House report, unless a check is dishonored, payment by check is a cash payment. See 124 CONG. REC. 32,400 (1978). See also 124 CONG. REC. 34,000 (1978) (similar statement by Senator DeConcini). For an overview of court attempts to deal with this controversy, see Note, "Transfers by Check": The 90-Day Rule of Preference Recovery Under Section 547(b) of the Bankruptcy Code, 1987 DUKE L.J. 712 (1987).

45. See A.I. Credit Corp. v. Drabkin (In re Auto-Train Corp.), 49 Bankr. 605, 612 (Bankr. D.D.C. 1985) ("The 'new value' defense is grounded in the principle that the transfer of new value to the debtor will offset the payments, and the debtor's estate will not be depleted to the detriment of other creditors"), aff'd, 800 F.2d 1153 (D.C. Cir. 1986).

46. Id.

47. 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.

48. Id.

III. NEW VALUE

Since a creditor must provide new value to come within the section 547(c)(1) or section 547(c)(4) exceptions, the definitional boundaries of new value are critically important. The Bankruptcy Code includes a list of items and transactions that qualify as new value. Courts differ over whether the list within the statutory definition of new value is exclusive. One court that considered the definition to be open-ended found support in the provision’s legislative history. In that history, Congress stated that new value was meant to be defined in its ordinary sense, and is defined in the Code only to prevent confusion.

Other courts, however, focus on Congress’ choice of statutory language, and find the statutory list exclusive. The Bankruptcy Code’s rules of construction suggest that the use of “includes” creates an open-ended definition. Had Congress wished to create an open-ended definition, it could have stated what new value “included.” Congress chose not to extend further credit to a debtor in shaky financial condition if the creditor fears that bankruptcy is imminent. In a bankruptcy distribution, a creditor likely would not receive 100% of any extension of credit, and the creditor could be forced to return any past payments made by a debtor within the preference period. The 547(c)(4) exception protects any preferential payments to the extent they are matched by subsequent extension of credit. Thus, it encourages creditors to extend credit to financially troubled debtors.

50. “New value” means money or money’s worth in goods, services, or new credit, or release by a transferee of property previously transferred to such transferee in a transaction that is neither void nor voidable by the debtor or trustee under any applicable law, including proceeds of such property, but does not include an obligation substituted for an existing obligation. 11 U.S.C. § 547(a)(2) (1988).


52. LaRose v. Crosby & Son Towing, Inc. (In re Dick Henley, Inc.), 38 Bankr. 210, 213 (Bankr. M.D. La. 1984) (“If the Congressional intent was to define ‘new value’ in its ordinary sense, the list of ‘goods, services, or new credit’ must not be exclusive”).

53. See H.R. Rep., supra note 16, at 372, reprinted in 1978 U.S. CODE CONG. & ADMIN. NEWS 5963, 6328; S. Rep. No. 989, 95th Cong., 2d Sess. 87, reprinted in 1978 U.S. CODE CONG. & ADMIN. NEWS 5787, 5873 (“Subsection (a) contains three definitions. Inventory, new value, and receivable are defined in their ordinary senses, but are defined to avoid any confusion or uncertainty surrounding the terms”).


not to do so; instead, Congress stated what "new value" meant. Thus, these courts reason, Congress did not create an open-ended definition.

IV. JUDICIAL CONSTRUCTION OF NEW VALUE

Courts have expanded the definition of new value to include forbearance of an existing remedy, forbearance in perfecting a statutory lien, a release of a letter of credit, and the making and honoring of a guarantee. Expanding the boundaries of new value provides the protection of the new value exceptions to many creditors. This, in turn, makes fewer transfers voidable. The net result is that creditors keep otherwise voidable transfers. This result undermines the prime bankruptcy goal of equality of distribution among creditors.

A. Forbearance of Existing Remedies

Most courts have not viewed the forbearance of an existing remedy as new value. A minority of courts have, however, held that a forbearance is new value if the non-action by the creditor makes possible the continued use of property essential to a debtor's business.

The earliest decisions under the Bankruptcy Code held that a forbearance was not new value. The bankruptcy court, in In re Duffy, held that a creditor's decision not to repossess the debtor's leased car did not constitute new value because the forbearance did not enhance the

57. See supra note 50 and accompanying text.
63. 3 Bankr. 263 (Bankr. S.D.N.Y. 1980).
value of the debtor's estate. The court viewed the forbearance as a substitution of an obligation for an existing obligation: the creditor exchanged a right of immediate possession of the car for a future right of repossession. This, the court noted, was expressly excluded by the statutory definition of new value.

The bankruptcy court, in Remes v. Yeomans (In re Quality Plastics), distinguished Duffy and found that new value existed when a lessor failed to repossess a machine necessary to the operation of the debtor's business. The court held that the sale of products created by the machine augmented the estate to the creditors' benefit. Since the creditor's forbearance was an essential prerequisite to the debtor's use of the machine, the court held that forbearance of repossession constituted new value. The subsequent new value given by the creditor was sufficient to protect the transfer from avoidance.

The Court of Appeals for the D.C. Circuit, in Drabkin v. A.I. Credit Corp., expressly disagreed with the approach taken in Quality Plas-

64. Id. at 266.
65. Id.
66. See also 11 U.S.C. § 547(a)(2) (1988) (new value “does not include an obligation substituted for an existing obligation”).
68. Id. at 243.
69. Id.
70. Id. The court rejected the trustee's argument that the new value found was speculative. Id. The court identified the new value as the accrual of unpaid post-transfer rentals. Such accrual was an unsecured debt. Thus, under the court's analysis, the new value represented a release of an unsecured debt. Id.
71. Id. The Eleventh Circuit, in dictum, expressed some support for a position analogous to that in Quality Plastics. See Charisma Inv. Co. v. Airport Sys., Inc. (In re Jet Florida Sys.), 841 F.2d 1082, 1084 (11th Cir. 1988) (lessor's refusal to terminate a lease might be new value if debtor stayed and used the property). See also 11 U.S.C. § 547(e)(4) (1988).
72. 800 F.2d 1153 (D.C. Cir. 1986). The debtor was Auto Train Corporation (Auto Train). The creditor, A.I. Credit Corporation (AICCO), was a premium financing company, a company that loaned money to enterprises to enable them to prepay yearly property and casualty insurance policies. Id. at 1154-55. AICCO loaned Auto Train $1,357,347.99 to purchase an insurance policy. Id. at 1155. AICCO took a security interest in the policy's unearned premiums and retained the rights, if Auto Train defaulted, to cancel the policy and to reclaim the unearned premiums. AICCO designed a repayment plan that ensured that the available funds of unearned premiums always exceeded the unrepaid portion of the loan. The repayment schedule's effect ensured that AICCO would be oversecured at all times, provided that Auto Train made its scheduled payments. But when a check offered for payment by Auto Train was dishonored, AICCO had the option of canceling the policy, recovering approximately one million dollars, and taking a $300,000 loss on the loan. AICCO chose, however, not to cancel the policy. The parties created a new repayment plan under which Auto Train made sporadic payments totalling $155,000 during the 90 days prior to its bankruptcy filing. Id. The Drabkin court held that these payments were preferential. Id. at 1157. The
tics. The Drabkin court held that the forbearance of an existing right could not constitute new value.\textsuperscript{74} The court, however, declined to rely on the rationale provided by the Duffy court.\textsuperscript{75} Instead, it offered an analysis based on the bankruptcy principle of equality of distribution among creditors.\textsuperscript{76} In the Drabkin court's view, the Quality Plastics approach allowed undersecured creditors\textsuperscript{77} an opportunity to use the threat of repossession to reduce the unsecured portion of their claim.\textsuperscript{78} If the undersecured collateral were necessary to the operation of a debtor's business, the creditor would have great leverage to force a preferential payment.\textsuperscript{79} Defining such forbearance as new value allowed a creditor the use of the two new value exceptions.\textsuperscript{80} The Drabkin court believed such a result encouraged creditors to force preferential payments, a consequence completely at odds with the principles underlying preference avoidance.\textsuperscript{81}

B. New Value and Statutory Liens

Although a properly perfected statutory lien\textsuperscript{82} is protected from preference avoidance,\textsuperscript{83} payments to holders of unperfected statutory liens court also held that AICCO's action in choosing not to cancel the insurance amounted to a forbearance, and, as such, did not constitute new value sufficient to shield the preference from avoidance. \textit{Id.} at 1159.

73. \textit{Id.}
74. \textit{Id.}
75. \textit{Id.} at n.7.
76. \textit{Id.} at 1159.
77. An undersecured creditor is one whose security interest in collateral has a fair market value less than the creditor's claim. Thus, a portion of the creditor's claim is unsecured. \textit{See} 11 U.S.C. § 506 (1988).
78. 800 F.2d at 1159.
79. \textit{Id.}
81. 800 F.2d at 1159. Judge Silberman noted that the court's decision could induce undersecured creditors to foreclose earlier on debtors. However undesirable this result, the court found it better than the alternative of favoring undersecured creditors at the expense of general unsecured creditors. \textit{Id.} The court also asserted that its holding had the advantage of providing legal certainty to parties in a commercial transaction, a result a contrary decision could not bring about. \textit{Id.} at n.9.
82. Statutory liens make specific property security for the payment of a debt. \textit{See generally} 53 C.J.S. LIENS § 8 (1987). State statutes often provide liens to people supplying labor, equipment, or materials in a construction project. \textit{See generally} 57 C.J.S. MECHANIC'S LIENS § 1 (1948). For the liens to be effective, they must be perfected by filing a statement with a court within a statutorily defined time. \textit{See, e.g.}, Mo. Ann. Stat. § 429.170 (Vernon 1952 & 1991 Supp.) (six months for a contractor, 60 days for a day laborer).
83. 11 U.S.C. § 547(c)(6) (1988) (excepting from avoidance the fixing of a statutory lien that is not avoidable under 11 U.S.C. § 545). Since the holder of a properly perfected lien has a secured
may be subject to preference attack, and creditors have attempted to shield these transfers through the use of the two new value exceptions.

Litigation concerning new value and statutory liens has focused on a few discrete areas of dispute. Most courts accept that new value must have some "value." Thus, the property subject to the lien must have some monetary worth if the lien is to have value. Courts split, however, over whether a forbearance in perfecting a lien constitutes new value. Those courts that find new value in a forbearance to perfect split further over whether new value may be found in the reduction of a third party's unsecured contingent claim for indemnification that results from a payment to an unperfected lien holder.

1. Waiver of a Statutory Lien on Valueless Property

Courts differ over whether new value requires appraisal of the value given. The Court of Appeals for the Tenth Circuit, in *Kenan v. Fort Worth Pipe Co. (In re George Rodman)*, held that no appraisal was necessary. *George Rodman* involved the release of a properly perfected lien held on an exploratory oil well. The owner discovered the oil well was worthless. The court held that section 547(a)(2)'s plain language did not require appraisal of the property transferred in the exchange. The court held that the release of the valueless lien constituted new value contemporaneously given sufficient to shield a payment to the creditor from avoidance.

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84. See infra notes 103-16 and accompanying text.
87. See infra notes 98-102 and accompanying text.
88. See id.
89. See infra notes 103-19 and accompanying text.
90. See infra notes 117-34 and accompanying text.
91. See infra notes 92-102 and accompanying text.
92. 792 F.2d 125 (10th Cir. 1986).
93. Id. at 128.
94. Id. at 126.
95. Id.
96. Id. at 128.
97. Id. Although a payment in exchange for the release of a properly perfected lien generally will not be a preference, see supra note 83, an exception may exist where the value of the property securing the lien is less than the creditor's claim. If the property is worthless, a payment may enable...
The Tenth Circuit appears subsequently to have abandoned *George Rodman* in *Lowrey v. U.P.G., Inc. (In re Robinson Brothers Drilling, Inc.)*. The court interpreted *George Rodman* to mean that no valuation was required at the time of an adversarial hearing, as long as the lien had some value at the time of the transfer.

The Court of Appeals for the Ninth Circuit, in *Milchem, Inc. v. Fredman (In re NuCorp Energy, Inc.)*, held that a release of a right to perfect a statutory lien did not constitute new value when, at the time of the transfer, the underlying property subject to the lien was valueless. The Ninth Circuit, however, declined to reach the issue of whether forbearance from perfecting a lien could, in and of itself, constitute new value.

### 2. Waiver of a Lien Right Against a Debtor's Property

Several early decisions under the Bankruptcy Code held that a creditor's forbearance in perfecting a statutory lien constitutes new value. The bankruptcy court, in *Weill v. Evans Lumber Co. (In re Johnson)*, held that relinquishing a right to perfect a lien constituted new value. The court stated that the definition of new value was meant to continue a rule established by judicial interpretations under the old Bankruptcy Act. Under such interpretations, a transfer to a creditor that discharged an inchoate lien was not an avoidable preference. The *Johnson* court found that such transfers did not diminish the debtor's assets available to pay other creditors; thus, they did not prefer the creditor.
Several courts have followed the Johnson court analysis.\textsuperscript{109}

The Northern District of Texas, in Cimarron Oil Co. v. Cameron Consultants, Inc.,\textsuperscript{110} however, declined to follow Johnson and its progeny.\textsuperscript{111} The Cimarron court held that, because a forbearance to perfect a statutory lien was not within new value's exclusive statutory definition, the forbearance was not new value and could not protect a transfer from avoidance.\textsuperscript{112}

The Cimarron court suggested a means of obtaining an equitable result without sacrificing principled statutory interpretation.\textsuperscript{113} The court held that section 547(c)(6),\textsuperscript{114} an exception that protects the fixing of certain statutory liens, protected the transfer from avoidance.\textsuperscript{115} Relying on the legislative history to the exception, the court found a congressional intent to shield from avoidance transfers that preclude the imposition of statutory liens.\textsuperscript{116}

3. \textbf{Waiver of Lien Rights Against Third Parties}

Courts differ over whether a waiver of lien rights against third parties


\textsuperscript{110} 71 Bankr. 1005 (N.D. Tex. 1987).

\textsuperscript{111} \textit{Id.} at 1009-10.

\textsuperscript{112} \textit{Id.} at 1009. The court found the definition exclusive because Congress stated what new value meant, rather than what new value "included." \textit{Id.} See also supra notes 54-57 and accompanying text.

\textsuperscript{113} 71 Bankr. at 1010-11. The equitable concern to which the court refers may be the same as identified in LaRose v. Crosby & Sons Towing, Inc. (\textit{In re} Dick Henley, Inc.), 38 Bankr. 210 (Bankr. M.D. La. 1984). The \textit{Dick Henley} court suggested a debtor could pay his creditors within 90 days of the bankruptcy, wait until after the statutory period for lien perfection and then file an action to recover a preference. The creditor, having received payment, would have no way to protect his lien right. The \textit{Dick Henley} court viewed this as inequitable. \textit{Id.} at 215.


\textsuperscript{115} 71 Bankr. at 1010-11.

\textsuperscript{116} \textit{Id.} Some courts have questioned the \textit{Cimarron} court’s analysis of the legislative history of § 547(c)(6). See, e.g., Simon v. Engineered Protection Sys., Inc. (\textit{In re} Hatfield Elec. Co.), 91 Bankr. 782 (Bankr. N.D. Ohio 1988). The \textit{Hatfield Electric} court stated that the legislative history reveals that language broadening the § 547(c)(6) exception to include satisfaction of statutory liens was deleted from the statute before passage of the final bill. \textit{Id.} at 786 (citing H.R. REP., supra note 16, at 374, \textit{reprinted in} 1978 U.S. CODE CONG. & ADMIN. NEWS 5963, 6330; S. REP., supra note 53, at 88, \textit{reprinted in} 1978 U.S. CODE CONG. & ADMIN. NEWS 5787, 5874). The \textit{Hatfield} court refers to language stating that the (c)(6) exception protects transfers in satisfaction of such liens, language not reflected in the statute. \textit{See} S. REP., supra note 53, at 88, \textit{reprinted in} 1978 U.S. CODE CONG. & ADMIN. NEWS 5787, 5874. \textit{See also} Note, supra note 86, at 100-01 (student author states a view similar to that of \textit{Hatfield} court).
constitutes new value. A bankruptcy court, in *LaRose v. Crosby & Son Towing, Inc. (In re Dick Henley, Inc.)*, held that, when a waiver of lien rights against a third party's property results in the reduction of a debtor's contingent liability for indemnification, the reduction constitutes new value. In *LaRose*, a creditor-subcontractor held a lien on property on which the creditor had worked. The property owner held a claim for indemnification against the debtor-general contractor. Upon receiving a payment from the debtor, the creditor released its lien against the owner, and the owner released the indemnity claim against the debtor. The court held that a release or reduction of an indemnity claim, in these circumstances, constituted contemporaneously exchanged new value sufficient to protect the payment to the creditor from avoidance.

The Court of Appeals for the Eleventh Circuit, in *Nordberg v. Arab Banking Corp. (In re Chase & Sanborn Corp.)*, described the *LaRose*
holding as a "circular and ill-founded evasion of the policy against preferential transfers."\textsuperscript{125} Looking to the facts in \textit{LaRose}, the Nordberg court reasoned that if the debtor-general contractor had not made the preferential payments, the subcontractor would have foreclosed its lien on the owner's property.\textsuperscript{126} The owner would then have enforced its unsecured right of indemnification against the debtor.\textsuperscript{127} Thus, the only value the debtor gained was the release of a contingent, unsecured, antecedent debt.\textsuperscript{128} The payment preferred one creditor without providing anything of tangible value to the debtor's estate.\textsuperscript{129} In the court's view, such payment depleted the estate to other creditors' detriment—the very essence of a preference.\textsuperscript{130}

Similarly, \textit{Simon v. Engineered Protection Systems (In re Hatfield Electric Co.)}\textsuperscript{131} held that the release of an unsecured claim for indemnity did not constitute new value.\textsuperscript{132} The court stated that the release of the indemnity claim, which resulted from the waiver of a lien, did not fit within the exclusive definition of new value.\textsuperscript{133} The court rejected judicial expansion of new value, finding that such expansion was not within its power and would conflict with the congressional purpose of promoting equal distribution among creditors.\textsuperscript{134}

\section*{C. Letters of Credit}

In some circumstances, a creditor may provide new value indirectly through a third party. The Court of Appeals for the Fifth Circuit, in \textit{Gulf Oil Corp. v. Fuel Oil Supply & Terminaling, Inc. (In re Fuel Oil Supply & Terminaling, Inc.)},\textsuperscript{135} held that a creditor's release of a letter of

\begin{thebibliography}{99}
\bibitem{125} Id. at 596 (dictum).
\bibitem{126} Id.
\bibitem{127} Id.
\bibitem{128} Id.
\bibitem{129} Id.
\bibitem{130} \textit{Id}. See also \textit{Gulf Oil Corp. v. Fuel Oil Supply & Terminaling, Inc. (In re Fuel Oil Supply & Terminaling, Inc.)}, 837 F.2d 224, 230 (5th Cir. 1988) (dictum criticizing \textit{LaRose}). The Eleventh Circuit stated that it agreed fully with the Fifth Circuit's reasoning. \textit{See} 904 F.2d at 596.
\bibitem{131} 91 Bankr. 782 (Bankr. N.D. Ohio 1988).
\bibitem{132} Id. at 785.
\bibitem{133} Id.
\bibitem{134} Id. The court viewed expansion of the definition of new value to be a legislative rather than judicial function. \textit{Id}. See also \textit{Note, supra} note 86, at 104-05 (student author argues that courts have invaded a congressional function by expanding the definition of new value to include the forbearance of a statutory lien).
\bibitem{135} 837 F.2d 224 (5th Cir. 1988). \textit{Gulf Oil} involved a transaction between two oil companies. The creditor, Gulf Oil Corp. (Gulf), supplied the debtor, Fuel Oil Supply and Terminaling, Inc.
credit\textsuperscript{136} constituted new value.\textsuperscript{137} The court set forth two conditions for finding new value in such circumstances.\textsuperscript{138} First, the creditor's release must be followed by the issuing bank's release of collateral securing the letter of credit.\textsuperscript{139} Second, the issuing bank must be fully secured.\textsuperscript{140} In the court's view, the release of the letter of credit made possible the release of the collateral.\textsuperscript{141} Since the collateral's release offset the debtor's transfer, the exchange did not deplete the debtor's estate to other creditor's disadvantage.\textsuperscript{142} The court held that the section 547(c)(1) exception protected the transfer.\textsuperscript{143}

\textbf{D. Guarantees}

A creditor's guarantee\textsuperscript{144} of a debtor's obligation may constitute new value. Guarantees may shield a preferential transfer in two ways. A court may view the creditor's guarantee as a contemporaneous transfer of new value,\textsuperscript{145} or a court may view the later honoring of a guarantee as a subsequent transfer of new value.\textsuperscript{146} The Third Circuit exhaustively ad-

\begin{itemize}
\item \textsuperscript{136} A letter of credit is "[a]n engagement by a bank . . . made at the request of a customer that the issuer will honor drafts or other demands for payment upon compliance with the conditions specified in the credit." \textbf{BLACK'S LAW DICTIONARY} 903-04 (6th ed. 1990). \textit{Gulf Oil} involved a standby letter of credit. 837 F.2d at 225. A standby letter of credit "commits the issuer to honor the credit . . . upon evidence or a mere declaration of the customer's default in the underlying transaction with the beneficiary." \textbf{BLACK'S LAW DICTIONARY} 904 (6th ed. 1990). \textit{See generally} Baird, \textit{Standby Letters of Credit in Bankruptcy}, 49 U. CHI. L. REV. 130, 133-36 (1982); McLaughlin, \textit{Letters of Credit as Preferential Transfers in Bankruptcy}, 50 FORDHAM L. REV. 1033, 1036-40 (1982).
\item \textsuperscript{137} 837 F.2d at 230-31.
\item \textsuperscript{138} \textit{Id}.
\item \textsuperscript{139} \textit{Id}.
\item \textsuperscript{140} \textit{Id}. However, if an issuing bank were undersecured, its release of collateral would not offset completely the preferential payment to the creditor. In that event, the preferential transfer would deplete the estate to the detriment of other creditors. \textit{Id}.
\item \textsuperscript{141} \textit{Id} at 228-29.
\item \textsuperscript{142} \textit{Id} at 230.
\item \textsuperscript{143} \textit{Id} at 231. \textit{See also} 11 U.S.C. § 547(c)(1) (1988).
\item \textsuperscript{144} A guarantee is "[a]n agreement in which the guarantor agrees to satisfy the debt of another (the debtor), only if and when the debtor fails to repay." \textbf{BLACK'S LAW DICTIONARY} 705 (6th ed. 1990).
\item \textsuperscript{145} \textit{See, e.g.}, Reigle v. Mahajan (\textit{In re} Kumar Bavishi & Assoc.), 906 F.2d 942 (3d Cir. 1990).
\item \textsuperscript{146} \textit{See, e.g.}, Bergquist v. Anderson-Greenwood Aviation Corp. (\textit{In re} Bellanca Aircraft
\end{itemize}
dressed this issue in *Reigle v. Mahajan (In re Kumar Bavishi & Associates)*. 147 By a vote of two to one, the court held that a personal guarantee constituted new value. 148

*Kumar Bavishi* involved a financially troubled limited partnership to which a bank refused to provide new credit, unless the limited partners individually guaranteed repayment. 149 The partnership owed an antecedent debt to the limited partners. 150 In order to induce one of the limited partners to provide a guarantee, the general partner paid a portion of the antecedent debt to the limited partner. 151 This payment equalled the limited partner’s expected exposure on the guarantee. 152 Although it found this payment to be a preference, the Third Circuit held that section 547(c)(1) protected the payment from avoidance. 153

The majority in *Kumar Bavishi* viewed the guarantee as a necessary factor that enabled the partnership to receive an infusion of new credit. 154 Thus, the court held that the guarantee constituted new value under the statutory definition as either “new credit” or “services.” 155 In the majority’s view, an increased cash flow from the loan process placed the debtor in a better position than it had been in before the transfer. 156

The majority found that the transfer did not deplete the debtor’s estate. 157 The court attempted to balance the transaction by matching loan proceeds with the debtor’s obligation to repay. 158 It next matched the preferential payment to the limited partner with a reduction in the un-
secured debt the debtor owed to the limited partner who provided the guarantee. The court viewed this interaction as an equivalent interaction that did not deplete the debtor's estate.

Judge Cowen dissented. He argued that the personal guarantee was neither new credit nor services and therefore was not within the statutory definition of new value. Since multiple guarantees were made, each guarantor might claim that his guarantee equalled the entire loan proceeds. Such a valuation would result in advancing a total amount of new value far in excess of the amount of the loan. If the court valued the guarantee at the portion of the new loan that the guarantors eventually honored, the guarantors, together, would have a new value claim equivalent to the amount of the loan. The bank also had a potential new value claim for the amount of the loan proceeds. Thus, a single loan could provide twice its amount in new value. The dissent viewed either possible valuation as absurd and unfair.

In addition, Judge Cowen refused to accept the majority's characterization of the guarantee as a service. For the guarantee to be "money's worth" in a "service," it is necessary to value the guarantee at the time of exchange. He suggested that to properly value the guarantee as a service, one could consider both the expected and the potential liability, and then discount that amount by the possibility of the debtor's default. However, the guarantee's value at the time of transfer would not neces-

159. Id.
160. Id. It is questionable how the court can justify its view that a reduction in unsecured debt is an equivalent exchange for a preferential transfer. A transfer to an unsecured creditor that reduces an antecedent unsecured debt would appear to be the essence of a preference. See 11 U.S.C. § 547(b) (1988).
161. 906 F.2d at 946 (Cowen, J., dissenting).
162. Id. at 947.
163. Id. at 948.
164. Id. There were at least five other guarantors in Kumar Bavishi. Id.
165. Id.
166. Id.
167. Id. The guarantors honoring their guarantee will extinguish the bank's claim against the debtor. The bank could, however, shield payments made by the debtor, for antecedent debts, prior to the loan by characterizing the loan as subsequent new value. See 11 U.S.C. § 547(c)(4) (1988).
168. 906 F.2d at 948.
169. Id.
170. Id. at 948-49.
171. Id. at 949 (citing Creditor's Comm. v. Spada (In re Spada), 903 F.2d 971 (3d Cir. 1990)).
172. Id. at 948.
sarily equal the amount of the preference. Judge Cowen asserted that the section 547(c)(1) exception only shielded a transfer to the extent the creditor gave new value. Because the record lacked any evidence of the guarantee's actual value as a service, Judge Cowen concluded that the exception did not apply.

Judge Cowen also rejected any analysis that viewed the guarantor's honoring of the guarantee as subsequent new value provided to the debtor. He argued that such an analysis incorrectly focused on a detriment to a preferred creditor, rather than on whether the honoring of the guarantee had augmented the debtor's estate. He found that no benefit accrued to the debtor upon the subsequent honoring of the guarantee. In his view, the honoring of the guarantee merely shifted the creditors' identity, and the guarantors now had an unsecured claim against the debtor. Thus, he found that neither the giving nor the honoring of the guarantee constituted new value.

V. Analysis

Preference law's primary purpose is to ensure an equal distribution among creditors. This purpose reinforces bankruptcy's role as a collective debt-collection proceeding. However, courts that expansively define new value allow too many creditors to use the exceptions to preference avoidance. Such expansive construction of new value undercuts
the efficacy of preference law and the effectiveness of bankruptcy itself. A narrow construction of new value brings fewer creditors within the exceptions to preference avoidance and allows the congressionally mandated balance of preference and exception to operate as designed.

Under the better view, forbearance from the exercise of an existing legal remedy is not new value. Neither the statutory definition nor the underlying principles of preference law support holding that a creditor's forbearance constitutes new value. As the D.C. Circuit illustrated, a finding by courts of new value in forbearance could encourage creditors to force preferential payments. Such a result undercuts the bankruptcy principle of equal distribution among creditors.

Similarly, failure to perfect a statutory lien should not be viewed as new value. The first bankruptcy court that characterized it as such did not attempt to apply new value's statutory definition. Instead, the court simply assumed that prior decisions under the repealed Bankruptcy Act automatically applied to the new Bankruptcy Code. However, forbearance in the perfection of a statutory lien is not within the Bankruptcy Code's exclusive list of what constitutes new value. Furthermore, the failure to perfect a lien because of a payment presents equitable concerns if the payment is avoided. The Cimarron court, however, provided an avenue by which principled statutory interpretation may be balanced with equity. Such an approach is more appropriate than dis-

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184. See generally Drabkin v. A.I. Credit Corp., 800 F.2d 1153, 1158-59 (D.C. Cir. 1986).
185. Because a creditor must provide new value to fall within the § 547(c)(1) or § 547(c)(4) exceptions, a narrow construction of new value necessarily prevents some creditors from using the exceptions.
188. See Drabkin, 800 F.2d at 1158-59.
189. Id. at 1159.
190. Id.
193. Id. For a discussion of the since-repealed Bankruptcy Act, see supra note 106.
194. See Cimarron Oil Co., 71 Bankr. at 1009.
196. See 71 Bankr. at 1010-11. This avenue consists of using the § 547(c)(6) exception to shield
torting new value to achieve an equitable result in one set of cases.\textsuperscript{197}

The release of an unsecured indemnity claim should not constitute new value as well. Payments to creditors in satisfaction of antecedent unsecured debts are nearly always preferences if made within the preference period.\textsuperscript{198} Yet, the \textit{LaRose} court held that such a payment was protected because a third party's release of an unsecured claim constituted new value sufficient to bring the transfer within an exception.\textsuperscript{199} This result illustrates that the consequence of judicial decisions that overly expand the reach of new value is to protect clearly preferential transfers from avoidance.

In contrast, the Fifth Circuit, keeping with congressional intent, held that a release of a standby letter of credit that results in a fully secured issuing bank's release of collateral to a debtor is new value.\textsuperscript{200} A three-way transaction should not inherently prevent the debtor from receiving new value.\textsuperscript{201} The key to the Fifth Circuit's analysis was the release of a fully secured claim on the debtor's property.\textsuperscript{202} This release completely offset the debtor's payment, and the release of the letter of credit did not deplete the debtor's estate to other creditors' detriment.\textsuperscript{203} Thus, the court's finding of new value in these circumstances did not undermine the primary bankruptcy principle of equality of distribution among creditors.

As with forbearances of legal remedies, failures to perfect statutory liens and releases of unsecured indemnity claims, a guarantee is not new value. The Third Circuit's analysis\textsuperscript{204} in so construing a guarantee is flawed.\textsuperscript{205} The dissent presented the better view. Neither the granting nor the honoring of the guarantee provided new value sufficient to shield the preference. As the dissent illustrated, to construe the guarantee as new credit presents inherent valuation problems.\textsuperscript{206} To regard the guar-
antee as a "service" is a potentially better approach if the value of the service were ascertainable. Such value could be the fair market value of the guarantee at the time the guarantor made it. This fair market value likely would be less than the amount eventually honored, and less than the amount of credit that the guarantee helped make possible. A fair market value of the guarantee made in *Kumar Bavishi* likely would have been insufficient to completely shield that preferential transfer.

The creditor's subsequent honoring of the guarantee did not provide new value to the debtor's estate. The dissent correctly viewed the post-petition payment as merely shifting the unsecured creditors. No new value offset the previous preferential payment.

Contrary to the majority's analysis, the granting of the guarantee did deplete the estate to other creditors' detriment. Although the debtor partnership received an infusion of cash from the bank, a concurrent obligation to the bank matched this cash. Cash flowed from the partnership to an unsecured creditor in return for a reduction of unsecured debt. The majority incorrectly applied the new value provided by the bank to both transactions. The dissent appropriately observed that the new value exception only shielded a transfer to the extent the creditor gave new value. No new value offset the preferential payment to the limited partner. The payment depleted the debtor's estate.

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207. *Id.* at 948.
208. For a suggested calculation of such a fair market valuation, see *id.* at 948. See also *In re Xonics Photochemical, Inc.*, 841 F.2d 198, 200 (7th Cir. 1988) ("[t]o value a contingent liability it is necessary to discount it by the probability that the contingency will occur and the liability become real") (Posner, J.).
209. *See* 906 F.2d at 948.
210. *Id.*
211. *See supra* notes 176-80 and accompanying text.
212. *See* 906 F.2d at 951.
213. *Id.*
214. For the majority's analysis of this issue in *Kumar Bavishi*, see *supra* notes 157-60 and accompanying text.
215. *See* 906 F.2d at 945.
216. *Id.*
217. *Id.*
218. *See* 906 F.2d at 949.
219. It can be argued that some new value was given in that the guarantor provided the fair market value of the guarantee to the debtor. *See supra* notes 172-75 and accompanying text. However, the dissent correctly pointed out that this valuation likely was less than the preferential payment by the debtor. 906 F.2d at 948. Thus, even if some new value was given, it was insufficient to completely protect the preference from avoidance. *Id.*
220. If no new value was given, creditors were deprived of the whole preference. If some new
ajority’s finding of new value in the granting of the guarantee undermines the primary bankruptcy principle of equal distribution among creditors.

VI. CONCLUSION

Courts should construe “new value” in a manner that reflects the exclusive statutory definition. Furthermore, courts should apply that definition in a way that supports the principles underlying preference law. Transfers that deplete the debtor’s estate to other creditors’ detriment should not be protected from avoidance by an improper use of the new value exceptions. Congress mandated a statutory framework of avoidable preferences and exceptions. Courts should not upset that balance.

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value was given, see supra note 219, then creditors were deprived of the portion of the preference not offset by the fair market value of the guarantee. Id.


222. See, e.g., Drabkin v. A.I. Credit Corp., 800 F.2d 1153 (D.C. Cir. 1986).