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Loan Payments to Secured Creditors as Preferences Under the 1984 Bankruptcy Amendments

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I. INTRODUCTION

On July 10, 1984, President Reagan signed into law the Bankruptcy Amendments and Federal Judgeship Act of 1984 (the "1984 Bankruptcy Amendments").[1] This enactment made many sweeping changes in both the substantive and procedural law of bankruptcy. Perhaps the most interesting and important of the substantive changes are those affecting the law of preferences. The purpose of this article is to examine those changes from a very particular focus,

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1. Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, 98 Stat. 333 (to be codified primarily in 11 U.S.C. and scattered sections of 28 U.S.C.). Except as otherwise expressly provided, all citations in this article to Title 11 of the United States Code shall be to such title, as amended by the 1984 Bankruptcy Amendments, without reference to a specific code service. For an overview of the many changes brought about by the 1984 Bankruptcy Amendments, see Miller & Bienenstock, *Bankruptcy Restructuring Promises Few Reforms*, Legal Times, July 30, 1984, at 30, col. 1.

that of the secured creditor receiving a loan payment during the period of the debtor's slide into bankruptcy.

II. OVERVIEW OF PREFERENCE LAW UNDER THE BANKRUPTCY CODE

Bankruptcy Code § 547(b) sets out the basic elements of a preference.[2] In order to establish an avoidable preference under that section, the trustee must allege and prove[3] each of the following facts: (1) a transfer of property of the debtor;[4] (2) to or for the benefit of a creditor; (3) for or on account of an antecedent, or pre-existing, debt; (4) made while the debtor was insolvent; (5) made either (i) "on or within 90 days before the date of the filing of the petition," or (ii) "between ninety days and one year before the date of the filing of the petition," if the creditor is an insider[5] of the debtor; and (6) which enabled the creditor to receive more than it would have received without the transfer in a Chapter 7 liquidation.[6] If the trustee fails to establish any of these elements, there is no avoidable preference.[7]

The first two elements of a preference are easily understood, and should normally be simple to establish. For example, a gratuitous transfer is not a preference because it is not to or for the benefit of a creditor.[8] In the typical case, the trustee should be able to satisfy the fourth requirement simply by resort to Bankruptcy Code § 547(f),

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2. 11 U.S.C. § 547(b).
3. Bankruptcy Code § 547(g), a provision added in 1984, clearly provides that the trustee has the burden of proving the avoidability of a § 547(b) preferential transfer. 11 U.S.C. § 547(g). This new provision codifies pre-existing caselaw. *See, e.g.*, Barash v. Public Fin. Corp., 658 F.2d 504, 507 (7th Cir. 1981).
4. The term "transfer" is broadly defined in § 101 of the Bankruptcy Code to include any voluntary or involuntary disposition of property or an interest in property. 11 U.S.C. § 101(48). Thus, both the creation of security interests in the debtor's property and loan payments made by the debtor to a secured party *may* result in a preferential transfer under bankruptcy law.
5. Bankruptcy Code § 101(28) defines the term "insider" broadly to include, *inter alia*, relatives of individual debtors and officers, directors and controlling persons of corporate debtors. 11 U.S.C. § 101(28).
6. 11 U.S.C. § 547(b). Unlike under the Bankruptcy Act of 1898, Ch. 541, 30 Stat. 544 (repealed 1978), there is no requirement that the trustee prove that the creditor receiving the preferential transfer had reasonable cause to believe that the debtor was insolvent at the time of the transfer. The 1984 amendments eliminated the last vestige of this subjective element when they deleted the requirement from the insider preference provisions. *See* 11 U.S.C. § 547(b)(4)(B).
7. *See, e.g.*, Barash v. Public Fin. Corp., 658 F.2d 504, 507 (7th Cir. 1981).
8. Butz v. Wheeler (*In re* Wheeler), 17 Bankr. 85, 88 (Bankr. S.D. Ohio 1981). Although the first element of a preference, the requirement that the subject of the transfer must be property of the debtor, is normally not a disputed issue in preference litigation, from time to time the courts have had occasion to construe it. *See, e.g.*, *In re* General Office Furniture Wholesalers, Inc., 42 Bankr. 232 (Bankr. E.D. Va. 1984); *In re* Tinnell Traffic Services, Inc., 41 Bankr. 1018, 1020 (Bankr. M.D. Tenn. 1984).

which creates a rebuttable presumption that the debtor was insolvent "on and during the 90 days immediately preceding the date of the filing of the petition."[9] Moreover, since a creditor is almost always better off with than without a prepetition transfer, the sixth element should be met in all cases except those in which the preferred creditor was fully secured before the transfer or in which the estate has sufficient assets to fund a 100 percent distribution to all general, unsecured claims.[10]

Both the antecedent debt and preference period requirements involve the chronology of the allegedly preferential transfer, and whether or not they are satisfied in any given case will generally be determined by application of Bankruptcy Code § 547(e), which adopts a clear and exhaustive test for the timing of a transfer for purposes of bankruptcy preference analysis.[11]

Once the trustee succeeds in establishing all of the elements of a section 547(b) preference, it then becomes necessary to consider the possible application of Bankruptcy Code § 547(c), which enacts a number of exceptions to the general rules of preference law in bankruptcy.[12] Section 547(c) recognizes that certain transactions constituting preferences within the meaning of section 547(b) should nevertheless be protected from the reach of the trustee to the extent necessary to effectuate overriding considerations of policy.

It is important to recognize that section 547(c) does not create any affirmative avoidance powers in the trustee. Thus, it applies only in concert with section 547(b). If the trustee fails to establish a prefer-

9. 11 U.S.C. § 547(f). Under FED. R. EVID. 301, the effect of this presumption is to shift to the preferred creditor the burden of going forward with evidence to rebut the presumption. The ultimate burden of persuasion on the issue of the debtor's insolvency remains with the trustee. *See, e.g., In re* Emerald Oil Co., 695 F.2d 833, 837-39 (5th Cir. 1983). For a case in which the transferee succeeded in rebutting the presumption of insolvency, see *In re* Thomas Farm Systems, Inc., 18 Bankr. 541 (Bankr. E.D. Pa. 1982).

10. For example, assume that a creditor has a claim against the debtor of $100,000 and valid-in-bankruptcy collateral of $150,000. If such creditor receives a $10,000 payment within 90 days of bankruptcy no preference results, because the payment has not enabled it to receive more than it would have received in Chapter 7 had the transfer not been made. With the transfer, the creditor receives the $10,000 payment and $90,000 in Chapter 7 from the collateral; without the transfer, it would receive $100,000 in Chapter 7 from the collateral. In either case, the creditor is paid in full and the bankruptcy estate retains the debtor's equity in the collateral. *See, e.g.* Barash v. Public Fin. Corp., 658 F.2d 504 (7th Cir. 1981); *In re* Utility Stationery Stores, Inc., 12 Bankr. 170, 179 (Bankr. N.D. Ill. 1981); *In re* Conn, 9 Bankr. 431 (Bankr. N.D. Ohio 1981); *In re* Zuni, 6 Bankr. 449 (Bankr. D.N.M. 1980).

11. For a discussion of Bankruptcy Code § 547(e), see Duncan, *Delayed Perfection of Security Interests in Personal Property and the Substantially Contemporaneous Exchange Exception to Preference Attack*, 62 NEB. L. REV. 201, 205-09 (1983).

12. 11 U.S.C. § 547(c).

ence under section 547(b), judgment should be rendered for the transferee. It is only after the trustee has met his or her burden under section 547(b) that it becomes necessary to determine whether section 547(c) protects all or part of the transfer from avoidance.[13] Under Bankruptcy Code § 547(g), a provision added by the 1984 Bankruptcy Amendments, the recipient of the transfer under attack has the burden of establishing nonavoidability under section 547(c).[14]

III. LOAN PAYMENTS TO SECURED CREDITORS AND PREFERENCE LAW

Loan payments made to fully secured creditors are not preferences, because they do not enable the transferee to improve its position outside of bankruptcy.[15] This is simply a straightforward application of Bankruptcy Code § 547(b)(5)—with or without the payment, the fully secured creditor will be paid in full and the bankruptcy estate will retain any equity of the debtor in the collateral.[16]

However, when an *undersecured creditor* receives a payment on an outstanding loan during the preference period, the trustee will normally be in a position to establish a section 547(b) preference.[17] Such a transfer will have a preferential effect under Bankruptcy Code § 547(b)(5), because the pre-bankruptcy payment will necessarily reduce the unsecured claim of the creditor while leaving its secured claim intact.[18] For example, suppose that Debtor files a bankruptcy petition on January 1, 1985, and, on that date, the outstanding balance due Bank is $10,000 and the value of the collateral securing the loan is $5,000. Assume further that the Debtor has made three installment payments of $500 each to Bank during the 90-day prepetition preference period. Clearly, Bank is better off with these payments than without them, unless the estate has sufficient assets to pay unsecured claims in full.[19]

As demonstrated in the above examples, Bankruptcy Code

13. *See* Duncan, *supra* note 11, at 204.
14. 11 U.S.C. § 547(g).
15. 11 U.S.C. § 547(b)(5). *See supra* note 10 and accompanying text. *See, e.g., In re* Hale, 15 Bankr. 565 (Bankr. S.D. Ohio, W.D. 1981).
16. *See In re* Hale, 15 Bankr. 565 (Bankr. S.D. Ohio, W.D. 1981). For a discussion of the concept of full security and § 547(b)(5), see Ward & Shulman, *In Defense of the Bankruptcy Code's Radical Integration of the Preference Rules Affecting Commercial Financing*, 61 WASH. U.L.Q. 1, 41-47 (1983).
17. 11 U.S.C. § 547(b). *See, e.g.*, Barash v. Public Fin. Corp., 658 F.2d 504, 507-09 (7th Cir. 1981).
18. Barash v. Public Fin. Corp., 658 F.2d 504, 508-09 (7th Cir. 1981).
19. For example, assume in the textual hypothetical that upon liquidation the Debtor's estate is sufficient to fund only a 10 percent distribution to unsecured creditors. With the three installment payments, Bank will receive $7,000, computed as follows:

§ 547(b)(5) protects the interest of unsecured creditors in the bankruptcy estate without undermining the legitimate contractual expectations of secured creditors. Thus, the trustee's power to recover a prepetition payment from a secured creditor is limited to those cases where the payment has resulted in a depletion of the bankruptcy estate available for distribution to other creditors. Where the transferee does not improve its position at the expense of the estate as a result of a pre-bankruptcy transfer, such as when the debtor makes a loan payment to a fully secured creditor, preference law does not, and should not, result in avoidability.[20]

IV. LOAN PAYMENTS TO SECURED CREDITORS AND PREFERENCE LAW: EXCEPTIONS TO AVOIDABILITY UNDER THE REVISED BANKRUPTCY CODE

Assuming the trustee has established that a loan payment to a partially secured creditor (or to an unsecured creditor) is a preference under Bankruptcy Code § 547(b), are any of the exceptions set forth in revised section 547(c) applicable? Depending on the facts of the particular case, at least two of the recent bankruptcy amendments may be helpful.

First, if the debtor is an individual "whose debts are primarily consumer debts," new Bankruptcy Code § 547(c)(7) will protect any preferential transfer so long as "the aggregate value of all property that constitutes or is affected by such transfer is less than $600."[21] To take an example, suppose that within 90 days before bankruptcy a consumer debtor has made three installment payments of $300 each to an unsecured or undersecured creditor. Does section 547(c)(7) protect each of these payments, because each payment (i.e. each "transfer") is less than $600? Or does the exception apply only if the aggregate value of all preferences is less than $600? What if the debtor has made

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Installment Payments:	$1,500
Value of Collateral:	5,000
10 percent of Unsecured Claim:	500
	$7,000

However, without the three prepetition payments, Bank would receive only approximately $5,650 upon the Debtor's liquidation:

Installment Payments:	n/a
Value of Collateral:	5,000
10 percent of Unsecured Claim*	650
	$5,650

*(including the $1,500 attributable to the three unpaid installments)

See Barash v. Public Fin. Corp., 658 F.2d 504, 508-09 (7th Cir. 1981).

20. *See* 2 W. Norton, NORTON BANKRUPTCY LAW AND PRACTICE § 32.09 (1981).
21. 11 U.S.C. § 547(c)(7).

ten (or thirty) payments of $300 each to the creditor during the preference period? There is as yet no clear answer to these questions. However, counsel for the transferee in the above example could certainly argue persuasively that each of the payments fits literally within the language of the exception.

Under Bankruptcy Code § 547(c)(2), the so-called "ordinary course" exception, a preferential payment is immune from avoidance by the trustee provided that both the underlying debt and the payment are ordinary course transactions.[22] Specifically, in order to protect a payment or payments, the transferee must establish: 1) that the obligation being paid was incurred by the debtor in the ordinary course of business or financial affairs of both the debtor and the transferee; and 2) that the payment was made according to ordinary business terms and in the ordinary course of business or financial affairs of both the debtor and the transferee.[23]

The 1984 Bankruptcy Amendments eliminated an additional requirement that had limited the protection of the ordinary course exception to payments made within forty-five days after the debt was incurred.[24] Thus, the exception now seems to protect many more payments than it did previously, and, what is more, it appears to have the potential of swallowing much of the substance of preference law.

The critical issue concerning the scope of revised section 547(c)(2) is the interpretation of the ordinary course requirements. If the exception is construed very broadly, it could provide a major loophole through preference law for creditors, both short and long term, receiving payments during the period of the debtor's slide into bankruptcy. Prior to 1984, the cases generally rejected the argument that section 547(c)(2) protected creditors receiving regular installment payments on long-term debt during the preference period.[25] However, these

22. 11 U.S.C. § 547(c)(2).

23. *Id.*

24. The 45-day rule had restricted the coverage of the exception to transactions, such as utility bills and certain trade credit, which both opened and closed within a period of not longer than 45 days. The 45-day period was held to begin running when the debtor received the consideration for which he or she had bargained. *See, e.g.*, Barash v. Public Fin. Corp., 658 F.2d 504, 509-11 (7th Cir. 1981); *In re* Balducci Oil Co., 33 Bankr. 843, 846 (Bankr. D. Colo. 1983); *In re* Anders, 20 Bankr. 468, 469 (Bankr. M.D. Fla. 1982). The elimination of the 45-day rule by the 1984 amendments would appear to extend § 547(c)(2) to many more transactions, including, perhaps, installment payments of long-term secured and unsecured debt.

25. *See, e.g.*, Barash v. Public Fin. Corp., 658 F.2d 504, 509-11 (7th Cir. 1981); *In re* Anders, 20 Bankr. 468, 469 (Bankr. M.D. Fla. 1982). Some courts distinguished between payments of principle, which were not protected, and payments of interest, which were protected if made within 45 days after the interest accrued. *See, e.g.*, *In re* Iowa Premium Service Co., Inc., 695 F.2d 1109 (8th Cir. 1982); *In re* R.A. Beck Builder, Inc., 34 Bankr. 888, 893 (Bankr. W.D. Pa. 1983). For an article criticizing this distinction, see Anderson, *In re Iowa Premium Service Co.: When Is a*

cases typically turned on application of the forty-five day rule and, therefore, provide little guidance to the meaning of "ordinary course" in this context.[26]

Until the caselaw develops in this area, creditors seeking to protect installment payments from preference attack ought to argue that, as a result of the elimination of the forty-five day rule, they now fit literally within the language of revised section 547(c)(2). For example, a bank extending long-term credit could argue in good faith that it is in the business of making such loans and that the debtor's business ordinarily requires such borrowings from time to time.

On the other hand, the trustee seeking to recover installment pay-

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Debt Incurred Under 547(c)(2) of the Bankruptcy Code, 17 CREIGHTON L. REV. 1075 (1984).

26. The few cases that have discussed the meaning of "ordinary course" do little to clarify the problem under discussion. For example, in the *Barash* case the court simply asserted, without discussion, that consumer installment loans and "regular" installment payments thereof were ordinary course transactions. *Barash v. Public Fin. Corp.*, 658 F.2d 504, 509 (7th Cir. 1981). *See also In re* McCormick, 5 Bankr. 726, 730 (Bankr. N.D. Ohio 1980). *Barash* was controlled by the since-departed 45-day rule, and, hopefully, if a similar case arises under revised § 547(c)(2), the Seventh Circuit will more fully explore the meaning of the ordinary course requirement. The following is a representative sampling of recent cases that have construed the ordinary course requirement: *In re* Economy Milling Co., 37 Bankr. 914, 922 (D.S.C. 1983) (the ordinary course requirement does not protect any transaction "that deviates from normal business practice"); *In re* Amex Trading Co., 37 Bankr. 793, 796 (Bankr. W.D. Tenn. 1984) (the court looked to the "history of buying and selling of agricultural chemicals" between the debtor and the transferee and concluded that the transactions did not reflect any "unusual dealings" that would take them outside the ordinary course exception); *In re* Arctic Air Conditioning, Inc., 35 Bankr. 107, 110 (Bankr. E.D. Tenn. 1983) (loan made by the spouse of the president and majority shareholder of debtor corporation to enable it to satisfy obligation for unpaid taxes was outside the ordinary course of business); *In re* Craig Oil Co., 31 Bankr. 402, 405-06 (Bankr. M.D. Ga. 1983) (payments made by cashier's check were not in the ordinary course of business because they were made to insure that the transferee would not join in an involuntary bankruptcy petition against the debtor and because the major shareholder of the debtor had personally guaranteed repayment of the underlying debt); *In re* Bagwell, 29 Bankr. 461, 465 (Bankr. D. Or. 1983) (the ordinary course exception "seems sufficiently broad to enable an assignee in a usual commerical transaction of bank financing based upon assigned invoices of shipment to treat the transfers as within terms of the exclusion"); *In re* Bagwell, 29 Bankr. 457, 461 (Bankr. D. Ore. 1983) (payments to bank, as assignee of debtor's supplier of lumber, were protected under the ordinary course exception because invoice financing is "a usual and integral part of commercial practice within the lumber industry"); *In re* Peninsula Roofing & Sheet Metal, Inc., 9 Bankr. 257, 261 (Bankr. W.D. Mich. 1981) (payments made after the debtor had closed its business and was attempting to dissolve were not made in the ordinary course of business and according to ordinary business terms); *In re* Williams, 5 Bankr. 706, 707-08 (Bankr. S.D. Ohio, W.D. 1980) (payments of $344.83 in the month before bankruptcy were not made in the "ordinary course of repayment" where the "usual rate of payment" was $28 per month).

ments as preferential transfers should argue that, even in its revised form, the ordinary course requirement is intended to distinguish between credit transactions that are typical or routine in the life or business of the debtor, such as the supply of goods and services on a short-term (although not necessarily a forty-five day) basis, and those which are atypical or unusual, such as long-term financings. Moreover, the primary policy of preference law, equality of distribution among similarly situated creditors, would appear to be better served by adoption of the typical/atypical test. This is true for two reasons. First, long-term loans (and installment payments thereof) are more likely to involve larger dollar amounts, and, therefore, will have a greater impact on the bankruptcy estate. Second, unlike the case of short-term financing of goods and services, in which value is given to the financially distressed debtor during his or her slide into bankruptcy, there is no offsetting addition to the estate in the period shortly before bankruptcy when a long-term creditor receives installment payments during the preference period.[27] Thus, the long-term installment payment clearly results in the depletion of the bankruptcy estate for the benefit of a particular creditor, exactly the situation that preference law generally seeks to discourage.[28]

V. CONCLUSION

The recent bankruptcy amendments made significant revisions in

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27. Unlike long-term lenders, short-term financers of goods and services provide equivalent value to the debtor within a limited time frame, and thus, help preserve the going concern value of the debtor's business:

> In fact, each of the . . . exceptions [of § 547(c)] involves an equivalent return to the debtor which generally is associated with the continuation of the business, such as short term trade credit and other 'like-cash' transactions, sale and acquisition of inventory, liquidation and creation of accounts, purchase money loans, and credit advances after payments.

Ward & Shulman, *supra* note 16, at 17 n.42.

28. *See* Anderson, *supra* note 25, at 1092-94. Further support for continuing to distinguish between short and long term credit under revised § 547(c)(2) is found in the limited legislative history of the provision. According to Senator Dole, one of the principle sponsors of the 1984 revision, the elimination of the 45-day requirement was designed to relieve buyers of commercial paper with maturities in excess of 45 days of the concern that repayments of such paper at maturity might be considered preferential transfers. 130 CONG. REC. S8897 (daily ed. June 29, 1984) (statement of Sen. Dole). Since long-term credit is generally not included within the commercial paper market, this statement could be read as supportive of the distinction made in the text. *See also* S. REP. NO. 65, 98th Cong., 1st Sess. 60 (1983) (stating that the 45-day limitation was deleted because it placed "undue burdens upon creditors who receive payment under business contracts providing for billing cycles greater than 45 days"). *Cf. In re* Independent Clearing House Co., 41 Bankr. 985, 1014 (Bankr. D. Utah 1984) ("it appears that the purpose of Section 547(c)(2) was to protect from preference liability ordinary trade credit transactions that are kept current, including payment of monthly utility bills").

the law of preferences. At least one of these changes, the elimination of the forty-five day rule from section 547(c)(2), has the potential of rendering the trustee impotent against creditors who receive preferential loan payments while other creditors go unpaid. If this possibility materializes, the primary policy of bankruptcy preference law, equality of distribution among similarly situated creditors, will be severely undercut. The bankruptcy courts should respond by construing the ordinary course requirement strictly so as to avoid extending its protection to preferential payments of long-term loans and other atypical financings. If Congress wishes to repeal the law of preferences in bankruptcy, it should act clearly and expressly. It has failed to do so in its revision of section 547(c)(2).