Preferential Transfers, the Floating Lien, and Section 547(c)(5) of the Bankruptcy Reform Act of 1978

Richard F. Duncan
University of Nebraska College of Law, rduncan2@unl.edu

Follow this and additional works at: http://digitalcommons.unl.edu/lawfacpub
Part of the Legal Studies Commons

Duncan, Richard F., "Preferential Transfers, the Floating Lien, and Section 547(c)(5) of the Bankruptcy Reform Act of 1978" (1982). College of Law, Faculty Publications. 150.
http://digitalcommons.unl.edu/lawfacpub/150

This Article is brought to you for free and open access by the Law, College of at DigitalCommons@University of Nebraska - Lincoln. It has been accepted for inclusion in College of Law, Faculty Publications by an authorized administrator of DigitalCommons@University of Nebraska - Lincoln.
Preferential Transfers, the Floating Lien, and Section 547(c)(5) of the Bankruptcy Reform Act of 1978

Richard F. Duncan *

I. INTRODUCTION

The major substantive provisions of the Bankruptcy Reform Act of 19781 have been in effect for more than two years,2 and flesh is beginning to form on the statutory skeleton. However, the New Act is still in its infancy, and many of its murky regions have yet to be charted by the courts and commentators. One such as yet indistinct area is section 547(c)(5),3 which creates a safe harbor for certain perfected security interests in commercial collateral that would otherwise fall prey to the trustee’s power to avoid preferential transfers. The primary purpose of this article is to assay the policy, substance and logic of section 547(c)(5), and to underscore the symbiotic relationship between that section and section 547(b) of the New Act.4

In order to take into account changing commercial practices and the widespread adoption of the Uniform Commercial Code, the Bankruptcy Reform Act substantially reformed the substantive law of preferential transfers.5

* Associate Professor of Law, University of Nebraska College of Law.


4. 11 U.S.C. § 547(b) (Supp. IV 1980). Section 547(b) establishes the power of the trustee in bankruptcy to avoid preferential transfers of property of the debtor. Section 547(c)(5) creates an exception to that power in the case of certain transfers of perfected security interests in inventory, receivables or the proceeds thereof.

Section 547(b) of the New Act provides that the trustee may avoid as preferential any transfer of property of the debtor:

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

The first element, that the transfer be made to or for the benefit of a creditor, should normally be subject to mechanical application. In the typical case, the trustee should be able

6. The term "transfer" is broadly defined in § 101 of the New Act to include any voluntary or involuntary disposition of property or an interest in property. 11 U.S.C. § 101(40) (Supp. IV 1980). Thus, both absolute conveyances of, and creation of security interests in, the debtor's property may result in a preferential transfer under § 547(b). See In re Gruber Bottling Works, Inc., 16 Bankr. 348, 351 (Bankr. E.D. Pa. 1982).


8. See D. Epstein & J. Landers, Debtors and Creditors: Cases and Materials 467 (2d ed. 1982). For example, a gratuitous transfer is not a preference
to satisfy the third requirement simply by resort to section 547(f), 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 fifth element should be met in all cases except those where the preferred creditor was fully secured before the transfer or the chapter 7 distribution is 100 per cent to all general, unsecured claims.10

The second and fourth elements both involve the chronology of the allegedly preferential transfer, and, although they should be easy to establish in most cases, they are of critical importance when applied to a floating lien11 under


10. See Epstein & Landers, supra note 8, at 468; R. Henson, Handbook on Secured Transactions Under the Uniform Commercial Code 12 (2d ed. 1979 Supp.); Henson, The Uniform Commercial Code and the New Bankruptcy Act: Some Problem Areas, 35 Bus. Law. 83, 92 (1979). 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 him to receive more than he 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 his collateral; without the transfer, he would receive $100,000 in chapter 7 from his collateral; in either case, the creditor is paid in full and the debtor's bankruptcy estate retains the debtor's equity in the collateral. See Barash v. Public Fin. Corp., 658 F.2d 504 (7th Cir. 1981); In re Conn, 9 Bankr. 431 (Bankr. N.D. Ohio 1981); In re Zuni, 6 Bankr. 449 (Bankr. D.N.M. 1980); J. White & R. Summers, Handbook of the Law Under the Uniform Commercial Code § 24-4, at 1004-05 (2d ed. 1980).

11. The term "floating lien" is a metaphor applied to a security interest which "floats" or shifts with respect to either or both the property subject to the security interest and the amount of the obligation secured thereby. See Epstein & Landers, supra note 8, at 181. The typical floating lien covers both present and future extensions of credit made to the debtor, as well as present and future collateral owned by
attack by the trustee as a preference.

II. AFTER-ACQUIRED COLLATERAL AND PREFERENCE LAW—THE PROBLEM AND THE RESPONSE UNDER THE FORMER ACT

For purposes of bankruptcy preference law, when is a transfer of a perfected security interest in property made? Suppose, for example, that on January 1, 1982, SP makes a loan of $100,000 to D and retains and immediately perfects a security interest in all D's inventory and proceeds thereof "whether now owned or hereafter acquired." At the time of the loan, the value of D's inventory is $50,000. Two weeks later, on January 15, 1982, D purchases additional inventory with a value of $20,000. Was the "transfer" of a perfected security interest in this after-acquired inventory made on January 1, 1982, when SP perfected its original security interest, or on January 15, 1982, when D acquired the collateral?

One way to analyze the problem is to look to the perfection and attachment provisions of Article 9 of the Uniform Commercial Code. Under U.C.C. section 9-303, a security interest is perfected "when it has attached and when all of the applicable steps required for perfection have been taken." The concept of attachment is defined in section 9-
of the Code. In general, a security interest does not attach until all of the following have occurred: (i) the debtor has signed an adequate security agreement (or the collateral is in the possession of the secured party pursuant to agreement); (ii) the secured party has given "value"; and (iii) the debtor has rights in the collateral. The steps required for perfection are enumerated in sections 9-302, 9-304, 9-305 and 9-306 of the Code. Some security interests, such as purchase money security interests in consumer goods, are perfected automatically at the time of attachment without any additional requirements. However, a secured party generally perfects an Article 9 security interest either by filing a financing statement in the proper public office or by taking possession of the collateral.

In the hypothetical posed above, it could be argued that under the U.C.C. a perfected security interest in the January 15 inventory was not transferred to SP until January 15, 1982, when D acquired rights in the collateral and the security interest simultaneously attached and became perfected, and that, therefore, it is a transfer made for or on account of an antecedent debt (the January 1 loan) for purposes of bankruptcy preference analysis. However, this argument was rejected by an overwhelming majority of cases decided under section 60 of the Bankruptcy Act of 1898. These cases adopted a number of colorfully named theories to explain denial of the trustee's preference claim. Two of these

---

14. Id. at § 9-203.
17. E.g., id. at § 9-302(1)(d).
18. Id. at §§ 9-302, 9-304 to 9-305. See generally White & Summers, supra note 10, §§ 23-5 to 23-16, at 918-64.
20. See B. Clark, supra note 19, ¶ 6.6[1], at 6-40 to 6-41.
justifications, the so-called "Mississippi River"\textsuperscript{22} and "so far perfected"\textsuperscript{23} theories, in essence operated to relate the transfer of a perfected security interest in after-acquired collateral back to the time of the perfection of the original security interest.

The "Mississippi River" theory conceived of the collateral in a collective sense—the security interest was viewed as attaching to the entity or floating mass of present and future collateral at the time of the initial perfection, rather than to individual units or atoms of collateral as they were acquired by the debtor. Proponents of this theory argued that there was but a single transfer of the present and future mass of collateral to the secured party, that this transfer occurred at the time of the perfection of the original security interest, and that, therefore, it was made for present value and not on account of an antecedent debt.\textsuperscript{24} The problem with this argument is that it defies clearly expressed language in section 9-203(1)(c) of the Code providing that a security interest does not attach until the debtor has rights in the collateral.\textsuperscript{25} It has also been criticized by commentators as potentially

\begin{footnotesize}
\begin{enumerate}
\item This theory is also known as the "entity," "floating mass" or "res" theory. See B. Clark, supra note 19, ¶ 6.6[1], at 6-39; Countryman, Code Security Interests in Bankruptcy, 75 Com. L.J. 269, 277 (1970).
\item Professor Countryman, a critic of the theory, referred to it as "The Abracadabra, or the Transfer Occurred before It Occurred Theory." Countryman, supra note 22, at 277.
\item Kronman, The Treatment of Security Interests In After Acquired Property Under The Proposed Bankruptcy Act, 124 U. Pa. L. Rev. 110, 126 (1975). See B. Clark, supra note 19, ¶ 6.6[1], at 6-39; Countryman, supra note 22, at 277; Harrington, supra note 19, at 463; Macey, supra note 5, at 697-98. In Rosenberg v. Rudnick, 262 F. Supp. 635 (D. Mass. 1967), District Judge Ford explained the theory in these words: . . . inventory subjected to a security interest should be viewed as a single entity and not as a mere conglomeration of individual items each subject to a separate lien. . . . The security interest is in the entity as a whole, not in its individual components, and the transfer of property occurs when this interest in the inventory as an entity is created. Id. at 639. See also Grain Merchants of Indiana, Inc. v. Union Bank and Savings Co., 408 F.2d 209 (7th Cir.), cert. denied sub nom., France v. Union Bank and Savings Co., 369 U.S. 827 (1969); In re Portland Newspaper Publishing Co., 271 F. Supp. 395 (D. Ore. 1967), aff'd sub nom. on other grounds, DuBay v. Williams, 417 F.2d 1277 (9th Cir. 1969).
\item U.C.C. § 9-203(1)(c) (1972). See B. Clark, supra note 19, ¶ 6.6[1], at 6-39. See also U.C.C. § 9-204(1) & (2) (1962).
\end{enumerate}
\end{footnotesize}
shielding intentional preferences, in the form of deliberate buildups of collateral on the eve of bankruptcy, from the trustee’s avoiding powers.\footnote{26}

The “so far perfected” theory was based on language in section 60(a)(2) of the Former Act which provided that for purposes of determining when a purportedly preferential transfer had been made:

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.\footnote{27}

Thus, since an Article 9 security interest is subordinate to the rights of a lien creditor only when the lien is acquired “before the security interest is perfected,”\footnote{28} a security interest attaching to after-acquired collateral is shielded against lien creditors from the moment a financing statement is filed to perfect the original security interest.\footnote{29}

\footnote{26. See Harrington, supra note 19, at 464; Hogan, Games Lawyers Play With The Bankruptcy Preference Challenge To Accounts And Inventory Financing, 53 CORNELL L. REV. 553, 561 (1968). Professor Hogan was concerned that the debtor might liqui-
date other assets at crash or distress sales in order to feed the favored creditor’s after-
acquired collateral clause. Id. See also WHITE & SUMMERS, supra note 10, at 1008.}


\footnote{28. U.C.C. § 9-301(1)(b) (1972) (emphasis added). See id. at § 9-201.}

\footnote{29. Since the security interest in after-acquired collateral would be perfected, under the earlier filing, at the moment the security interest attached (i.e. upon the debtor’s acquiring rights in the collateral), the best a lien creditor of the debtor could achieve would be a draw. U.C.C. §§ 9-302, 9-303(1) (1972). See Hogan, supra note 26, at 557. It appears that the U.C.C. would grant priority to the security interest in the unlikely event of such a dead heat. U.C.C. §§ 9-201, 9-301(1)(b) (1972). See G. GILMORE, 2 SECURITY INTERESTS IN PERSONAL PROPERTY § 35.6, at 936-37 (1965); Young, supra note 5, at 232. Therefore, the trustee would be unable to show, as re-
quired by § 60(a)(2) of the Former Act, that a creditor on a simple contract could have acquired a “superior” lien on the after-acquired collateral at any time subsequent to the original filing. Under this view of § 60(a)(2), the hypothetical transfer of the January 15, 1982, inventory posed above would be deemed to have been made in exchange for present value on January 1, 1982, when the loan was made and the original security interest was created and perfected. See DuBay v. Williams, 417 F.2d 1277 (9th Cir. 1969); Grain Merchants of Indiana, Inc. v. Union Bank And Savings Co., 408 F.2d 209 (7th Cir.), cert. denied sub nom., France v. Union Bank and Savings}
A third theory, sometimes called the "relaxed substitution" theory, took the position that it was not a preference under the Former Act for a secured creditor to receive new collateral pursuant to an after-acquired property clause, at least to the extent that, from time to time during the preference period, existing collateral had been sold free of the security interest by the debtor. This theory did not relate the transfer of after-acquired collateral back to the time of the original security interest; instead, it posited a purely fictional scenario under which newly acquired collateral was deemed to be taken in exchange for the secured party's release of any pre-existing collateral sold by the debtor free of the security interest during the preference period. Under


30. A true substitution of collateral should not result in a preference, because there is no depletion of the debtor's estate and two of the essential elements of a preferential transfer are not present. See 11 U.S.C. § 547(b)(2) & (5) (Supp. IV 1980); 4 Collier on Bankruptcy § 547.22 (15th ed. 1979); Countryman, supra note 22, at 273, 277-78. A true substitution of collateral occurs when the transfer of the new collateral occurs prior to, or contemporaneously with, the release of existing collateral or equal of greater value. See id. Under the relaxed substitution theory, the time and value requirements are relaxed or completely overlooked. See infra note 32.

31. See B. Clark, supra note 19, ¶ 6.6[1], at 6-40.

32. For example, in Grain Merchants of Indiana, Inc. v. Union Bank and Savings Co., 408 F.2d 209, 217 (7th Cir.), cert. denied sub nom., France v. Union Bank and Savings Co., 396 U.S. 827 (1969), although the court relied in part on evidence of actual substitutions of new accounts in exchange for the release of previously collected accounts, it did not require "strict timing or value rules so long as at all relevant times the total pool of collateral...exceeded the total debt." Id. at 217. Under this view, it was irrelevant that the new collateral was not transferred prior to or contemporaneously with the release of the old collateral, and that the new collateral was of greater value than the released collateral. Id. at 217 n.10. Because of the requirement in Grain Merchants that there be a surplus of collateral over debt at all relevant times, the facts of the case would probably produce the same result under the "improvement in position" test enacted by § 547(c)(5) of the Bankruptcy Reform Act. See infra notes 96 and 97 and accompanying text. See also In re Portland Newspaper Publishing Co., 271 F. Supp. 395, 401 (D. Ore. 1967), aff'd sub nom. on other grounds, DuBay v. Williams, 417 F.2d 1277 (9th Cir. 1969).

33. Under this theory:

[a] security interest in newly acquired assets is considered to be taken in exchange for the secured party's release of his rights in existing assets. In other words...the secured party's interest in the new...assets is substituted for the interest in the released assets.

Harrington, supra note 19, at 465. See Macey, supra note 5, at 698. Professor Coun-
this reasoning, it therefore followed that there had been no depletion of the debtor's estate for the benefit of a favored creditor, and that the after-acquired collateral had been transferred for new value (i.e. the released collateral) and not on account of an antecedent indebtedness.\textsuperscript{34}

The final major theory insulating perfected security interests in after-acquired collateral against the trustee's preference attack under the Former Act was U.C.C. section 9-108, which provides that a security interest in . . . 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 . . . in the ordinary course of his business . . . . 35

U.C.C. section 9-108 is a Pickwickian attempt to define away the preference problem simply by declaring that security interests in after-acquired collateral are not given for antecedent debt.\textsuperscript{36} Although a few courts appear to have accepted this theory,\textsuperscript{37} its validity under the supremacy clause of the United States Constitution\textsuperscript{38} is suspect, because it attempts to resolve a federal bankruptcy question, i.e. whether or not a certain class of transfer under preference attack is for or on account of an antecedent debt, as a matter of state law.\textsuperscript{39}
III. AFTER-ACQUIRED COLLATERAL UNDER SECTION 547 OF THE BANKRUPTCY REFORM ACT

Competing state and federal policies clash deafeningly when a security interest in after-acquired collateral collides with the power of the trustee to avoid preferential transfers for the benefit of a bankruptcy estate. Supporting the security interest in after-acquired property are recognition of the commercial importance of floating lien financing and the reasonable expectations of secured lenders who extend credit in reliance on the validity and effectiveness of their after-acquired property clauses. 40 This is especially important in the case of inventory and accounts financing, because these kinds of collateral routinely turn over in the ordinary course of the debtor's business, and the secured party therefore must look to the after-acquired property clause to maintain the secured status of its loan at an adequate level. 41

40. Article 9 of the Code expressly rejected the "widespread nineteenth century prejudice against the floating charge." U.C.C. § 9-204, Comment 2 (1972). This former prejudice was based on the view that commercial borrowers should not be permitted to encumber all of their present and future assets for the benefit of one favored creditor. Id. However, as the process of industrialization continued, the credit requirements of business interests led to a search for new sources of collateral and, concomitantly, novel devices to validate the floating lien. Thus, even under pre-Code law it was possible to create a valid, enforceable lien on all of the debtor's present and future property. However, these pre-Code security devices were expensive, inefficient and needlessly multiplicative. In recognition of this pre-existing state of affairs, Article 9 expressly validated the floating lien and created a single device, the security interest, to regulate all consensual encumbrances in personal property and fixtures. See id.; I G. Gilmore, supra note 29, § 11.7; Kronman, supra note 24, at 117-19.

41. Current assets are by nature transient: the ongoing life of a business enterprise requires their continuous liquidation. A business holds inventory in order to sell it. In the ordinary course of business, inventory is sold and transformed into accounts receivable (or intangibles of some other sort); accounts receivable are paid and the proceeds used in the purchase of fresh inventory; and the entire cycle is begun again. Stagnation at any point is usually a symptom or a cause of commercial failure.
lenders secure their loans, one of their major concerns is survival of their security in the event of the debtor's insolvency. Bankruptcy is therefore the litmus test of security; if the after-acquired collateral clause is not protected in bankruptcy, lenders either will be denied access to an important source of security against the risk of commercial credit, or will be forced to resort to needlessly onerous, inefficient policing devices to protect their collateral. 42 In either case, credit is likely to become both more expensive and less freely available.

On the other hand, seminal bankruptcy policies seeking to discourage favoritism and foster equitable distribution of the assets of bankrupt debtors are also at stake. 43 The interests and reasonable expectations of unsecured creditors are the foundation of preference policy. Without preference law in bankruptcy, secured creditors and others receiving transfers of property of the debtor shortly before bankruptcy could obtain an unfair advantage over other claimants who also deserve protection. Preference law permits the trustee to recover certain prepetition transfers from favored creditors thereby maximizing the value of the bankruptcy estate for the benefit of all creditors. 44 However, as discussed in the

---

A loan secured by volatile collateral of this type must not impede the normal metamorphosis of assets from inventory to receivables to cash to inventory. The debtor must be free to liquidate the collateral securing the debt as his business requires; in order to keep the debt fully secured, however, fresh collateral of the same sort as the old collateral must take the latter's place as it is liquidated. This requires a revolving collateral scheme, which depends upon the recognition and protection of security interests in after-acquired property. A principal aim of the Article 9 floating lien is to provide a legal foundation for current assets financing, that is, for financing on the basis of inventory and receivables.


44. See HOUSE REPORT, supra note 5, at 177-78; Kronman, supra note 24, at 142.
immediately preceding section of this article, the case law under the Former Act erected an almost impenetrable, protective barrier around perfected security interests attaching to collateral during the preference period pursuant to after-acquired property clauses in valid pre-existing security agreements. The egalitarian goals underlying federal bankruptcy preference law were thereby sacrificed at the altar of state policy nurturing the floating lien, and unsecured creditors, including inventory suppliers dealing with the debtor on a credit basis, were denied access to what would otherwise be substantial assets of the debtor's bankruptcy estate.

Fundamental bankruptcy policies, although not inviolate, should be compromised only to the extent necessary to serve other, more important, state or federal purposes. The case law under the Former Act failed this litmus test. Simply put, these cases went too far—the far-reaching potential of their holdings was unnecessary from the standpoint of reasonable commercial expectations, and, consequently, was unsound as a matter of bankruptcy policy. The Congres-

To the extent that the trustee is able to avoid a perfected security interest as a preferential transfer, his recovery will be for the benefit of the debtor's unsecured creditors. See 11 U.S.C. § 550(a) (Supp. IV 1980) (trustee recovers avoided transfers "for the benefit of the estate"). An incidental purpose of the law of preferences is to discourage creditors “from racing to . . . dismember the debtor during his slide into bankruptcy.” HOUSE REPORT, supra note 5, at 177. However, the deterrent effect of preference law is limited in two ways. First, creditors without knowledge of the debtor's insolvency are unlikely to be deterred by preference law from accepting or seeking prepetition payments or recoveries on account of antecedent debt. Secondly, even some creditors who have knowledge of the debtor's severe financial straits may be willing to risk accepting a preference on the not entirely frivolous chance that it will not be recovered by the trustee. See McCoid, Bankruptcy, Preferences and Efficiency: An Expression of Doubt, 67 VA. L. REV. 249, 264 (1981). The elimination in most cases by the Bankruptcy Reform Act of the requirement that the trustee prove that the preferred creditor had reasonable cause to believe that the debtor was insolvent at the time of the transfer being attacked as preferential underscores the dominance of the policy of equality of distribution over that of deterrence under New Act preference law. See HOUSE REPORT, supra note 5, at 178. See also infra note 132 and accompanying text.

45. See supra notes 20 to 39 and accompanying text.
47. See NATIONAL BANKRUPTCY CONFERENCE, REPORT OF THE COMMITTEE ON COORDINATION OF THE BANKRUPTCY ACT AND THE UNIFORM COMMERCIAL
sional response to this situation was, typically, enactment of
a compromise, sections 547(e)\(^{48}\) and 547(c)(5)\(^{49}\) of the Bank-
ruptcy Reform Act.

Under section 547(e), most collateral acquired by the
debtor during the preference period is recaptured in the
trustee's preference net;\(^{50}\) section 547(c)(5) then rends a sig-
nificant, but less than complete, hole in that net, thereby per-
mitting a substantial amount of after-acquired collateral to
escape the trustee.\(^{51}\) The remainder of this article will at-
tempt to assay the logic and wisdom of this legislative at-
tempt to resolve a difficult problem.

A. Section 547(e)

The timing of a transfer is critical to three elements of
the trustee's section 547(b) preference attack.\(^{52}\) Section
547(e) of the New Act adopts a clear and exhaustive formu-
lation of when a transfer is made for purposes of bankruptcy
preference analysis.\(^{53}\)

With respect to Article 9 security interests in personal
property, section 547(e) applies a combination of three dis-
tinct, chronological factors to determine the timing of an al-


\(^{50}\) See infra Section III A.

\(^{51}\) See infra Section III B.

\(^{52}\) The timing of the transfer determines whether it has been made for or on
account of an antecedent debt, while the debtor was insolvent, and within the prefer-
ence period. 11 U.S.C. §§ 547(b)(2)-(4) (Supp. IV 1980). See supra notes 7 to 11 and
accompanying text.

\(^{53}\) Section 547(e) provides:

\(e\)(1) For the purposes of this section—

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

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

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

\(A\) at the time such transfer takes effect between the transferor and
legedly preferential transfer: (1) the time at which such transfer becomes effective between the debtor and the secured party;\textsuperscript{54} (2) the time at which such transfer is perfected against certain third parties;\textsuperscript{55} and (3) the time at which the debtor acquires rights in the collateral.\textsuperscript{56}

Under section 547(e)(2)(A), a transfer of a security interest in personal property will be deemed made, for purposes of bankruptcy preference law, at the time it attaches under section 9-203 of the U.C.C., provided it is perfected under the Code not later than ten days after attachment.\textsuperscript{57}

\begin{itemize}
  \item[(B)] at the time such transfer is perfected, if such transfer is perfected after such 10 days; or
  \item[(C)] immediately before the date of the filing of the petition, if such transfer is not perfected at the later of—
    \begin{itemize}
      \item[(i)] the commencement of the case; and
      \item[(ii)] 10 days after such transfer takes effect between the transferor and the transferee.
    \end{itemize}

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


\textsuperscript{54} 11 U.S.C. § 547(e)(2)(A) (Supp. IV 1980). Under the Code, a security interest becomes effective (i.e. enforceable) between the parties at the time of attachment. U.C.C. § 9-203(1) & (2) (1972). See supra notes 14 and 15 and accompanying text.

\textsuperscript{55} A transfer of an interest in personal property is perfected for purposes of § 547 "when a creditor on a simple contract cannot acquire a judicial lien that is superior to the interest of the transferee." 11 U.S.C. § 547(e)(1)(B) (Supp. IV 1980). This language, which is similar to the "so far perfected" test of § 60(a)(2) of the Former Act (see supra notes 27-29 and accompanying text), is in all material respects identical with the concept of perfection against lien creditors under article 9 of the Code. See U.C.C. §§ 9-201, 9-301(1)(b) (1972). See also supra notes 28-29 and accompanying text.

\textsuperscript{56} 11 U.S.C. § 547(e)(3) (Supp. IV 1980). The principal significance of § 547(e)(3) is with respect to security interests attaching to after-acquired collateral during the preference period. See infra notes 65-71 and accompanying text.

\textsuperscript{57} 11 U.S.C. § 547(e)(2)(A) (Supp. IV 1980). Although at first glance this provision appears similar to U.C.C. § 9-301(2), closer inspection reveals significant differences. Thus, the 10-day grace period under the Code is limited to purchase money security interests, while § 547(e)(2)(A) applies broadly to all transfers. Additionally, the 10-day period under the Code begins to run when the debtor "receives possession of the collateral," while under the Bankruptcy Reform Act the grace period starts "at the time [the] transfer takes effect between the transferor and the transferee." Compare U.C.C. § 9-301(2) (1972), with 11 U.S.C. § 547(e)(2)(A) (Supp. IV 1980). In a recent article, Professor Hogan criticized this failure of the New Act to conform to the Code:

If delivery is delayed the bankruptcy 10 days may well expire before the
In effect, section 547(e)(2)(A) gives the secured party a ten-day grace period following attachment to perfect its security interest. However, if the secured party perfects outside the grace period, the transfer will be deemed made at the time of perfection under section 547(e)(2)(B). Finally, if the secured party fails to perfect before the later of the expiration of the grace period and the commencement of the bankruptcy case, the transfer will be deemed to have been made “immediately before the date of the filing of the petition.”

The operation of section 547(e) is best explained by illustration. Suppose, for example, that on January 1, 1982, SP makes a loan to D and obtains an adequate security agreement creating a security interest in certain items of D's business equipment. Subsequently, on January 5, 1982, SP duly files a financing statement to perfect its security interest in the equipment. Under section 547(e)(2)(A), the security interest is deemed to have been transferred on January 1, 1982, when the loan was made and the security interest created, because SP perfected within ten days after the security interest attached to the equipment and became enforceable between D and SP.

Suppose further that instead of filing on January 5, 1982, SP waits until January 15, 1982, to perfect its security interest. Now section 547(e)(2)(B) applies and the transfer is deemed to have been made on January 15, 1982, the time of

UCC period begins. This difference makes no sense. If creditors are misled at all by the delay it is unlikely that they would be misled from the time the transfer takes effect between the parties when the debtor-buyer may not be in possession of the goods. Further the careful secured party may simply contract to make the transfer take effect at the time of delivery and thus get the full 10 days recognized in bankruptcy. The Bankruptcy Reform Act should simply measure the ten day period in purchase money cases from the time of delivery of the goods.


59. 11 U.S.C. § 547(e)(2)(C) (Supp. IV 1980). This section insures that the transfer will be treated as a prepetition transfer for purposes of § 547(b)(4) of the New Act. 11 U.S.C. § 547(b)(4) (Supp. IV 1980) (to be preferential, transfer must be made on, or within certain periods of time before, the filing of the bankruptcy petition).

Finally, suppose that SP never files a financing statement or otherwise perfects its security interest, and that D files a bankruptcy petition on January 12, 1982. These added facts trigger section 547(e)(2)(C), and the transfer is deemed to have been made "immediately before" the filing of the January 12 bankruptcy petition, because the security interest was not perfected at the time of bankruptcy and the ten-day grace period had already expired.\footnote{11 U.S.C. \$ 547(e)(2)(C) (Supp. IV 1980).}

Obviously, section 547(e) can have a critical impact on a transfer under preference attack. For example, consider the probable effect of section 547(e) on the three hypotheticals posed immediately above. The first transfer, which was perfected within the ten-day grace period on January 5, 1982, is not preferential under section 547(b)(2), because it is deemed to have been made on January 1, 1982, for contemporaneous, and therefore not antecedent, value (i.e. the loan made on that date).\footnote{11 U.S.C. \$ 547(b)(2) & (e)(2)(A) (Supp. IV 1980).} However, the latter two transfers are probably section 547(b) preferences, because they are deemed to have been made at times subsequent to the January 1 loan and therefore are treated as having been given in exchange for antecedent indebtedness.\footnote{This point assumes that in the second hypothetical the transfer was made within the appropriate preference period. All of the other elements of a \§ 547(b) preference appear to have been met. 11 U.S.C. \$ 547(b) (Supp. IV 1980). See \textit{In re Hall}, 14 Bankr. 186 (Bankr. S.D. Fla. 1981); \textit{In re Brimhall}, 13 Bankr. 942 (Bankr. D. Idaho 1981); \textit{In re Kelley}, 3 Bankr. 651 (Bankr. E.D. Tenn. 1980). It also discounts the potential application of the exceptions to the trustee's preference avoiding powers created by \§ 547(c). 11 U.S.C. \$ 547(c) (Supp. IV 1980). For example, in one recent case, debtor granted secured party a security interest in an automobile on December 10, 1980. This security interest was not perfected until January 12, 1981, more than 30 days later, due to circumstances beyond the control of the secured party. The court held that \§ 547(c)(1) protected the transfer from the trustee, because the parties intended a contemporaneous exchange for new value and the exchange was in fact "substantially contemporaneous." \textit{In re Arnett}, 13 Bankr. 267 (Bankr. E.D. Tenn. 1981), \textit{aff'd}, 17 Bankr. 916 (E.D. Tenn. 1982). See also \textit{In re Martella}, 22 Bankr. 649 (Bankr. D. Colo. 1982); \textit{In re Burnette}, 14 Bankr. 795 (Bankr. E.D. Tenn. 1981); \textit{In re Hall}, 14 Bankr. 186 (Bankr. S.D. Fla. 1981). However, a second line of cases takes a}
The most intriguing application of section 547(e) concerns the principal subject of this article, the floating lien on after-acquired collateral. Returning to the original hypothetical posed in Section II above, suppose that on January 1, 1982, SP makes a $100,000 loan to D and retains and immediately perfects a security interest in D's present and future inventory. D owns inventory with a value of $50,000 at the time of the making of the loan, and subsequently acquires additional inventory, worth $20,000, two weeks later, on January 15, 1982.

The inventory in existence at the time of the making of the loan triggers an elementary application of section 547(e)(2)(A)—the transfer is deemed to have been made on January 1, 1982, because the security interest was immediately perfected at the closing of the secured transaction.65 However, calculating the timing of the transfer of collateral acquired by D on January 15, 1982, requires resort to more sophisticated analysis. Although the definition of perfection contained in section 547(e)(1)(B) is very similar to the “so far perfected” test under section 60(a)(2) of the Former Act,66 a transfer of a security interest in after-acquired collateral does not relate back to the time of perfection of the original security interest under New Act preference law. Instead, a transfer of a security interest in after-acquired property is deemed to have been made not earlier than the time the debtor acquires rights in the collateral.

This scenario, which calls into question the validity in bankruptcy of all collateral transferred during the preference period under an after-acquired property clause in a pre-existing security agreement,67 is a consequence of section 547(e)(3) of the New Act.68 Section 547(e)(3) qualifies the general timing rules discussed above by providing that “a

---

65. See supra note 57 and accompanying text.
66. See Harrington, supra note 19, at 471.
67. See infra note 70 and accompanying text.
transfer is not made until the debtor has acquired rights in the property transferred. Thus, in the example above, the transfer of the security interest in the January 15 inventory is deemed to have been made on January 15, 1982, when the debtor acquired rights in the collateral and the security interest simultaneously attached and became perfected.

The impact of section 547(e)(3) on the floating lien is dramatic; for purposes of determining whether a security interest in after-acquired collateral is preferential, the relevant date in connection with the antecedent indebtedness, insolvency and preference period requirements of section 547(b) is that on which the debtor acquires rights in the collateral, and not that of perfection of the original security interest. As a result, most, if not all, security interests attaching to after-acquired collateral within ninety days of bankruptcy appear to be section 547(b) preferential transfers.

69. Id. This reference tracks a similar reference to the debtor’s “rights in the collateral” contained in U.C.C. § 9-203(1)(c), which defines the concept of attachment under the Code. U.C.C. § 9-203(1)(c) (1972). See supra notes 14 and 15 and accompanying text. Since the Bankruptcy Reform Act does not contain a formula for determining when a debtor has acquired rights in property for purposes of § 547(e)(3), the bankruptcy cases will probably look to case law under the Code for guidance. The concept of rights in the collateral under U.C.C. § 9-203 is not synonymous with title to, or even possession of, the property. The debtor may have obtained rights in goods even prior to shipment by the seller, and may have rights in an account even before it is earned. See WHITE & SUMMERS, supra note 10, § 23-4, at 917. See also U.C.C. §§ 2-501(1), 9-106 (1972); U.C.C. § 9-204(2) (1962). For a good discussion of the concept of rights in the collateral in the context of § 547(e)(3) of the Bankruptcy Reform Act, see Harrington, supra note 19, at 481-85.

70. Assume the original security interest was given in exchange for contemporaneous value, at a time before the preference period, and while the debtor was solvent. A transfer under preference scrutiny as of such date would be valid against the trustee, because three of the elements of § 547(b) would be absent. 11 U.S.C. § 547(b)(2)-(4) (Supp. IV 1980). However, if the debtor subsequently acquired collateral during the preference period, § 547(e)(3) would time the transfer as of the date of acquisition, and the transfer would therefore be made on account of an antecedent debt, during the preference period, and while the debtor was presumed to be insolvent. 11 U.S.C. §§ 547(b)(2)-(4), (e)(3), (f) (Supp. IV 1980). See In re Diversified World Investments, Ltd., 12 Bankr. 517 (Bankr. S.D. Texas 1981); In re Cox, 10 Bankr. 268 (Bankr. D. Md. 1981); Harrington, supra note 19, at 471.

71. Under § 547(e)(3), such transfers would be made within the preference period, on account of an antecedent debt, and while the debtor is presumed insolvent under § 547(f). 11 U.S.C. §§ 547(b)(2)-(4), (f) (Supp. IV 1980). See Harrington, supra note 19, at 472.
B. Section 547(c)(5)

i. General Operation

A lender with blinders on looking at section 547(e)(3) would likely seek out the escape of apoplexy, because he or she would appear to be witnessing the brutal demise of the floating lien in bankruptcy. However, section 547(e)(3) does not operate in a vacuum, and much of what that section denies floating lien secured parties is restored by section 547(c).

Section 547(c) enacts a number of exceptions to the general rules of preference law in bankruptcy. It recognizes that certain transactions constituting technical preferences under section 547(b) should be protected from the reach of the trustee to the extent necessary to effectuate overriding considerations of policy. Although any or all of the subsections of section 547(c) may, in a given case, spell relief for a transfer under preference attack, section 547(c)(5) is by far the most germane exception with respect to after-acquired inventory and receivables collateral.

Section 547(c)(5) provides:

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 interest [sic] 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; or

(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.73

It is critically important to recognize that section 547(c)(5) does not give the bankruptcy trustee any affirmative avoidance powers. Rather, it has quite the opposite effect—it provides an exception from avoidance for certain transfers that would otherwise be vulnerable under section 547(b).74 Thus, in any given case, it is not necessary to reach the question of application of section 547(c)(5) until after the trustee has met his burden of proving all of the necessary elements of a preference75 under section 547(b).76 If the trustee fails to prove that a section 547(b) preference has been made, judgment should be rendered for the transferee; only if the trustee meets his burden under section 547(b) is it necessary to determine whether section 547(c) exempts all or part of the transfer from avoidance.

Section 547(c)(5) applies only to transfers of perfected


74. See Nimmer, supra note 46, at 318; Young, supra note 5, at 225. Some courts and commentators have failed to discern the distinct functions of §§ 547(b) and 547(c)(5). See In re The Music House, Inc., 11 Bankr. 139 (Bankr. D. Vt. 1980); Kaye, supra note 5, at 211; Harrington, supra note 19, at 474.

75. The trustee has the burden of alleging and proving by a fair preponderance of the evidence all of the requisite elements of an alleged preferential transfer. If the trustee fails to meet his burden, no preference has been established under § 547(b). See Barash v. Public Finance Corp., 658 F.2d 504, 507 (7th Cir. 1981); In re Camp Rockhill, Inc., 12 Bankr. 829, 831-32 n.3 (Bankr. E.D. Pa. 1981); In re Burnham, 12 Bankr. 286, 297 (Bankr. N.D. Ga. 1981); In re Conn, 9 Bankr. 431, 434 (Bankr. N.D. Ohio 1981); 4 COLLIER, supra note 30, ¶ 547.55 Although § 547(f) of the New Act creates a rebuttable presumption that the debtor was insolvent during the 90-day period immediately preceding bankruptcy, the ultimate burden of persuasion on the issue of the debtor’s insolvency remains with the trustee. See supra note 9 and accompanying text.

76. For example, if the debtor was solvent at the time he acquired collateral, the secured party has not received a preference, because one of the requisite elements of § 547(b) has not been satisfied. 11 U.S.C. § 547(b)(3) (Supp. IV 1980). Therefore, in theory there is no need to apply § 547(c)(5) to such a transaction. However, in practice, counsel for the transferee might decide that it is easier to exempt a given transaction under § 547(c)(5) than to rebut the presumption of insolvency under §§ 547(b)(3) and 547(f). See supra note 9 and accompanying text.
security interests in inventory, receivables, or the proceeds of either. Transfers of other kinds of collateral, including security interests in business equipment, receive no protection from the trustee's avoidance powers. Thus, for example, all business equipment attaching to a financer's floating lien within ninety days before bankruptcy is probably subject to avoidance by the trustee as a preferential transfer, unless it is protected by some other provision of the Bankruptcy Reform Act.

77. "Inventory" is defined by the Bankruptcy Reform Act as:
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.

11 U.S.C. § 547(a)(1) (Supp. IV 1980). The main difference between this definition of inventory and that contained in the U.C.C. is that under the latter farm products are not classified as inventory.

78. A "receivable" is defined as a "right to payment, whether or not such right has been earned by performance." 11 U.S.C. § 547(a)(3) (Supp. IV 1980). Again, the Bankruptcy Reform Act definition of receivable is broader than its closest U.C.C. counterpart, the definition of 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 (1972). See Henson, supra note 10, at 97. See also U.C.C. § 9-105(b) & (i) (1972); U.C.C. § 9-106 (1962).


80. 11 U.S.C. § 547(c)(5) (Supp. IV 1980). See National Bankruptcy Conference, Report of the Committee on Coordination of the Bankruptcy Act and the Uniform Commercial Code (1970), reprinted in House Report, supra note 5, at 215; B. Weintraub & A. Resnick, Bankruptcy Law Manual § 7.05[8], at 7-21 and 7-22 (1980). This limitation reflects Congress' appreciation of the commercial significance of the after-acquired collateral clause in the context of inventory and accounts financing. See supra notes 40 and 41 and accompanying text. Since business equipment does not revolve in the ordinary course of the debtor's business, equipment financiers do not generally rely on after-acquired collateral clauses when calculating credit risks. Thus, § 547(c)(5) meets the most important requirements of commercial lenders without sacrificing unnecessarily the bankruptcy policy of equality and fairness to all creditors. See supra notes 43-51 and accompanying text; Note, supra note 42, at 248.


82. For example, suppose that during the preference period the secured party releases a valid-in-bankruptcy security interest in a particular item of equipment to enable the debtor to trade it in for new equipment collateral. If the released equipment is at least equal in value to the new equipment, there is no depletion of the debtor's estate and thus no preference. 11 U.S.C. §§ 547(a)(2), (b)(2), (b)(5) & (c)(1)
Although section 547(c)(5) is frequently said to adopt an “improvement in position” test, it actually enacts a two point reduction in deficiency formulation that works as follows in the typical case: first, calculate the collateral deficiency as of the date ninety days before bankruptcy; second, calculate the collateral deficiency as of the date of the filing of the bankruptcy petition; and third, calculate the amount of the reduction in collateral deficiency by subtracting the product of the second calculation from the product of the first calculation. The figure resulting from this arithmetic process designates the maximum extent of the trustee’s power to avoid a security interest in inventory or receivables under section 547(b).

Section 547(c)(5) therefore requires the secured status of floating lien creditors to be compared as of two points in time. Fluctuations in the interval between the two measuring points are irrelevant. The second of the two relevant dates will always be the date of the filing of the bankruptcy petition. Depending on the facts of the particular case, the initial measuring point will be one of three possible dates. In the great majority of cases, the date ninety days before the filing of the bankruptcy petition will be the relevant time for

---

83. See, e.g., HOUSE REPORT, supra note 5, at 374; WHITE & SUMMERS, supra note 10, § 24-5, at 1009.

84. Use of the term “collateral deficiency” in the text refers to the “amount by which the debt secured by such security interest exceed[s] the value of all security interest [sic] for such debt.” 11 U.S.C. § 547(c)(5) (Supp. IV 1980). For example, if on any relevant date the amount of the secured obligation is $100,000 and the value of all collateral is $75,000, the amount of the collateral deficiency is $25,000. Apparently all types of security, not just inventory, receivables and proceeds thereof, are to be taken into account when calculating the amount of the collateral deficiency. It may therefore be to the advantage of inventory and accounts financiers to negotiate for additional kinds of collateral when extending credit to commercial borrowers. See E. REILEY, GUIDEBOOK TO SECURITY INTERESTS IN PERSONAL PROPERTY § 8.7(c)(1), at 8-21 (1981); Reiley, Secured Creditors and the Bankruptcy Act of 1978, 14 U.S.F. L. REV. 341, 369 (1980).

the first calculation of collateral deficiency. However, if the preferred creditor is an insider and the transfer was made "between 90 days and one year before the date of the filing of the petition", the initial section 547(c)(5) calculation will be made as of "one year before the date of the filing of the petition." Finally, if new value was first given by the secured party after the date which would otherwise be the appropriate initial measuring point, section 547(c)(5)(B) provides that the initial calculation shall be made as of "the date on which new value was first given under the security agreement creating such security interest."

Section 547(c)(5)'s complexity is deceptive, and many courts and commentators have failed to discern its more abstruse features. The easy applications are almost childishly simple, and serve as bait to lure the unwary legal analyst into the trap set by its difficult applications. For example, where the amount of the outstanding indebtedness remains static at all relevant times, section 547(c)(5) generally produces a clear answer to questions regarding the extent of the trustee's avoiding power. The following hypothetical is illustrative. Suppose that ninety days before bankruptcy D, the owner of a sporting goods store, owes SP $100,000 under a pre-existing loan secured by present and after-acquired in-

89. 11 U.S.C. § 547(c)(5)(B) (Supp. IV 1980). Suppose, for example, that on January 1, 1982, SP loans D $10,000 and obtains an adequate security agreement covering D's present and future inventory. D then files a Chapter 7 petition on February 1, 1982. The two measuring points under section 547(c)(5) will be January 1, 1982, the date on which new value (i.e. the $10,000 loan) was first given under the security agreement, and February 1, 1982, the date D filed its petition in bankruptcy. Under these facts, it is obvious that January 1, 1982, must be chosen as the initial point of calculation, because the secured relationship between D and SP had not yet been established on the otherwise applicable date (i.e., 90 days before bankruptcy).
ventory. On this date, SP has a perfected security interest in D's $50,000\textsuperscript{91} inventory of football gear. By the date on which D files his chapter 7 petition, the stock of inventory has completely turned over and the $100,000 loan is secured under the after-acquired property clause by $75,000 worth of baseball equipment. What is the total amount of the trustee's preference recovery under section 547?

The first question to be answered is whether the trustee can prove that SP has received a section 547(b) preference. The answer to this question is almost certainly that SP has received a $75,000 preferential transfer of a perfected security interest in the baseball gear, because under section 547(e)(3) of the New Act this inventory was transferred to SP during the ninety-day preference period (i.e. at the time D acquired rights in the collateral),\textsuperscript{92} on account of an antecedent debt (i.e. the pre-existing loan of $100,000),\textsuperscript{93} and while D was presumed to be insolvent under section 547(f).\textsuperscript{94} However, under an elemental application of section 547(c)(5), the trustee's power to avoid this transfer is limited to $25,000, because SP has improved its secured position only to such extent.\textsuperscript{95} A second reasonably simple problem under section 547(c)(5) is the case of the floating lien creditor who is fully secured at the ninety-day measuring point. Such a creditor will generally be exempt from preference attack under sec-

\textsuperscript{91} In this article all questions of valuation of collateral will be assumed. In practice, the parties and the courts will have to establish these figures with only minimal guidance from the Bankruptcy Reform Act, a task which will almost certainly raise many difficult problems of an accounting nature. See Cohen, supra note 90, at 651-65; Harrington, supra note 19, at 473 n.99; Young, supra note 5, at 234.


\textsuperscript{93} See supra notes 65-71 and accompanying text.

\textsuperscript{94} 11 U.S.C. § 547(f) (Supp. IV 1980). See supra note 9 and accompanying text. The trustee should easily be able to establish the remaining elements of an avoidable preference. See 11 U.S.C. § 547(b)(1) & (5) (Supp. IV 1980); supra notes 8 and 10 and accompanying text.

\textsuperscript{95} The transfer involves a perfected security interest in inventory and the reduction in collateral deficiency between the 90-day measuring point ($100,000 debt minus $50,000 security equals a collateral deficiency of $50,000) and the date of the petition ($100,000 debt minus $75,000 security equals a collateral deficiency of $25,000) is equal to $25,000. See supra notes 83 & 84 and accompanying text.
tion 547(c)(5) with respect to inventory or receivables collateral acquired by the debtor during the preference period; by definition there is no collateral deficiency as of the initial measuring point, and the trustee will therefore be unable to demonstrate the necessary improvement in position as of the date of the petition. Thus, it is advisable for floating lienors to police their loans to insure that they remain adequately collateralized at all times. Of course, to the extent that a secured party has a good-in-bankruptcy security interest in collateral with a value greater than the amount of the secured indebtedness, the excess will be available to the trustee as part of the debtor's bankruptcy estate.

Although in the easy case section 547(c)(5) is capable of mechanical application, understandable even by those of us who have not been schooled in the new math, it can become almost a medieval instrument of torture when presented to students by a law professor with an active legal imagination. Suppose, for example, that ninety days before bankruptcy D owes SP $100,000 under a pre-existing loan secured by present and after-acquired inventory. On this date, SP has a perfected security interest in D's $30,000 inventory of football gear. Eighty-nine days before bankruptcy, SP loans D an additional $30,000 under a future advance clause contained in the original loan and security agreement thereby increasing the amount of the secured obligation to $130,000. By sixty days before bankruptcy, D's stock of inventory has completely turned over and the $130,000 loan is secured under the after-acquired property clause by $30,000 worth of baseball bats and gloves. Next, on the day before bankruptcy, D makes a $60,000 loan payment to SP. Finally, on the date D files his chapter 7 petition, the outstanding bal-

97. 11 U.S.C. § 547(c)(5) (Supp. IV 1980). See Levin, An Introduction to the Trustee's Avoiding Powers, 53 AM. BANKR. L.J. 173, 188 (1979); Macey, supra note 5, at 700; Nimmer, supra note 46, at 319. This remains true even if the value of the collateral dips below the amount of the debt during the 90-day period following the initial measuring point. See Levin, supra, at 188; Macey, supra note 5, at 700.
ance of the loan is $70,000, and the value of D’s inventory is $50,000.

What is the total amount of the trustee’s preference recovery under section 547? Depending upon how one reads section 547, there are at least four possible answers to this question: $50,000, $110,000, $80,000, and $60,000.

A superficial reading of the two-point test of section 547(c)(5) might suggest a recoverable preference of only $50,000, because that is the amount of the improvement in SP’s secured position between the ninety-day point and the date of bankruptcy.99 This solution fails to take into account the $60,000 loan payment made by D to SP on the day before bankruptcy, which appears to meet all of the requirements of a preference under section 547(b).100

99. The collateral deficiency 90 days before bankruptcy was $70,000 ($100,000 debt minus $30,000 security). On the date of bankruptcy, the deficiency had decreased to $20,000 ($70,000 debt minus $50,000 security). It follows that the amount of the improvement in SP’s secured position is $50,000. 11 U.S.C. § 547(c)(5) (Supp. IV 1980). See Clark, supra note 90, at 178; Cohen, supra note 90, at 650-51; Shanor, supra note 90, at 610.

100. It is a transfer of property of the debtor made to a creditor (i.e., SP), on account of an antecedent debt (i.e., the outstanding loan of $130,000), while the debtor was presumed to be insolvent under § 547(f), within 90 days before bankruptcy, and which enabled SP, who was not fully secured, to receive more than it would have received in a chapter 7 distribution had the payment not been made (assuming that the bankruptcy distribution to general creditors is less than 100%). 11 U.S.C. § 547(b), (e) & (f) (Supp. IV 1980). See Barash v. Public Finance Corp., 658 F.2d 504 (7th Cir. 1981); In re Satterla, 15 Bankr. 166 (Bankr. W.D. Mich. 1981); In re Hawkins Mfg., Inc., 11 Bankr. 512 (Bankr. D. Colo. 1981); In re McCormick, 5 Bankr. 726 (Bankr. N.D. Ohio 1980). For example, consider Professor Clark’s solution to the hypothetical posed in his excellent article on preferences under the Bankruptcy Reform Act:

...if a $20,000 debt is secured by $17,000 in collateral ninety days before bankruptcy, there would be no preference if, on the date of the petition, the debt was $9,000 and the collateral $6,000. Since the deficiency was $3,000 on both dates, there has been no “improvement in position.”

Clark, supra note 90, at 178. Professor Clark’s analysis of the problem fails to take into account the $11,000 loan payment made to the secured party during the preference period. This payment appears to be preferential under § 547(b) (assuming that the debt was undersecured at all relevant times), and it is not protected by § 547(c)(5) which protects only transfers of perfected security interests in inventory or receivables and the proceeds of either. 11 U.S.C. § 547(b) & (c)(5) (Supp. IV 1980). Without additional facts, it is impossible to determine whether one of the other subsections of § 547(c) or some other provision of the New Act would apply to protect some or all of the loan payment from the trustee’s avoiding powers.
A somewhat more careful reading of section 547 would recognize that there are two different types of preferential transfers involved in this problem—a $60,000 payment of the loan and a $50,000 perfected security interest in after-acquired collateral.102 Using this analysis as his starting point, the trustee could argue that the $60,000 payment is a preference for which no protection is given under section 547(c),103 and that the $50,000 security interest in D’s after-acquired inventory is fully avoidable (it appears to be a section 547(b) preference and is not exempt under section 547(c)(5) because there has been a $50,000 improvement in position).104 Under this view, the trustee’s total recovery would be $110,000.

A still more sophisticated analysis of the problem would go forward from this point to focus on the language in section 547(c)(5) limiting the trustee’s power to avoid otherwise preferential transfers of inventory and receivables to the extent that such transfers “caused” an improvement in position under the two-point test.105 SP could therefore argue that its security interest in the after-acquired inventory may be avoided only insofar as the value of its collateral increased between the two relevant dates (i.e. only to the extent of $20,000), because only to such extent was the improvement in its secured status caused by the transfers of after-acquired security.106 This theory produces a net recovery by the trustee under section 547 of $80,000, i.e. the $60,000 preferential loan payment and the $20,000 improvement.

The best reading of the preference provision takes the analysis yet one more step and recognizes that under the second and third theories discussed above double liability is imposed upon SP in connection with the $60,000 loan payment,

101. See supra note 100 and accompanying text.
102. Since D’s inventory completely turned over during the 90-day prepetition period, all of SP’s perfected security interest in the collateral was “transferred” during the preference period. 11 U.S.C. § 547(b)(4) & (e)(3) (Supp. IV 1980). See supra notes 65-71 and accompanying text.
103. See supra note 100 and accompanying text.
104. See supra note 99 and accompanying text.
106. Id. See Nimmer, supra note 46, at 321-22.
i.e. not only is the $60,000 payment recoverable by the trustee as a preference, but it is being taken into account in calculating whether SP has improved its position under section 547(c)(5). Thus, if the $60,000 payment had not been made, the amount of the debt on the date of bankruptcy would have been $130,000, the deficiency would have been $80,000 (i.e. $130,000 debt minus $50,000 security), there would have been no improvement in SP's secured status (since the deficiency would have increased from $70,000 to $80,000 between the two relevant dates), and there would therefore be no recoverable preference of after-acquired inventory under section 547(c)(5). 107

The ultimate solution to this problem accords with the analysis last mentioned, and is distilled from the relationship of section 547(c)(5) on the one hand, and sections 502(h) and 550(c) of the New Act on the other. Under section 502(h), SP's claim arising from the trustee's recovery of the $60,000 preferential loan payment is treated "the same as if such claim had arisen before the date of the filing of the petition," i.e. it is treated as a $60,000 prepetition claim. 108 SP should therefore argue that its $60,000 claim in connection with the trustee's recovery of the preferential loan payment should be taken into account under section 547(c)(5) in calculating the deficiency existing on the date of the filing of the petition. The trustee's recovery under this analysis would be limited to the $60,000 preferential payment, because under section 547(c)(5) there would be no improvement in position and thus no recoverable transfer of after-acquired inventory. 109 This analysis is bolstered by section 550(c), which provides that in recovering, inter alia, preferential transfers under sec-

109. The collateral deficiency ninety days before bankruptcy was $70,000 ($100,000 debt minus $30,000 security). As of the date of bankruptcy, the recomputed collateral deficiency is $80,000 ($70,000 debt plus $60,000 recovered preferential payment minus $50,000 security). The creditor's secured status therefore did not improve between the two relevant measuring points, and § 547(c)(5) thus exempts all of the inventory from the trustee's preference attack. 11 U.S.C. § 547(c)(5) (Supp. IV 1980). See Nimmer, supra note 46, at 322.
tion 547 the "trustee is entitled to only a single satisfac-
. . .". It is also consistent with the requirement in
section 547(c)(5) that a transfer of a perfected security inter-
est in after-acquired collateral is avoidable only when it
prejudices the interests "of other creditors holding unsecured
claims." To the extent that the collateral deficiency on the
date of bankruptcy has been reduced by a preferential loan
payment recoverable for the benefit of the estate by the
trustee, the bankruptcy estate has not been depleted and
other creditors of the debtor have therefore not been
prejudiced thereby. Finally, the suggested interpretation
takes into account the interface of all relevant sections of the
Bankruptcy Reform Act, and effectuates the policy of section
547(c)(5) by insulating the floating lien in inventory and re-
cievables from the trustee's avoiding power where there has
been no improvement in the aggregate secured position of
the floating lien creditor at the end of the ninety-day pre-
bankruptcy period.

ii. Prejudice Provision

The trustee is not home free under section 547(c)(5)
when he or she has established the requisite reduction in the

110. 11 U.S.C. § 550(c) (Supp. IV 1980). Cf. 4 COLLIERS, supra note 30, ¶
553.08[3].


112. See Nimmer, supra note 46, at 301, 321-22. The same analysis should apply
when a creditor that is secured by both inventory and equipment improves its position
as a result of the debtor's acquisition of new equipment during the preference period.
Suppose, for example, that 90 days before bankruptcy D owes SP $100,000 under a
pre-existing loan secured by present and after-acquired inventory and equipment. On
this date, SP has a perfected security interest in $30,000 worth of inventory and
$10,000 worth of business equipment. Subsequently, D acquires additional equip-
ment, and at the bankruptcy -day measuring point SP's $100,000 claim is secured by
$30,000 worth of inventory and $30,000 worth of equipment. The trustee should be
able to avoid the $20,000 security interest in the equipment acquired by the debtor
during the preference period, because it appears to be a § 547(b) preference and is not
protected by § 547(c)(5). See supra notes 81 & 82 and accompanying text. However,
the trustee should not be permitted to avoid any of SP's security interest in inventory,
because the $20,000 improvement in position resulted from the debtor's acquisition
of the new equipment, not from after-acquired inventory. Again, since the trustee is
able to avoid the $20,000 security interest in the new equipment, the bankruptcy es-
tate has not been depleted and there has been no improvement in SP's aggregate
secured position at the end of the 90-day period.
amount of the collateral deficiency; he or she must further demonstrate that the improvement in position was "to the prejudice of other creditors holding unsecured claims."\textsuperscript{113} Essentially, this means that the trustee must show that the effect of the improvement was to decrease the amount of property otherwise available for liquidation and distribution to unsecured creditors.

Although the Bankruptcy Reform Act does not provide any guidance as to the types of transactions protected or denied protection from the trustee by the prejudice provision, when a floating lienor improves its position as a result of new units of collateral acquired by the debtor during the preference period, the trustee should have little difficulty establishing that the after-acquired security interest, if recognized in bankruptcy, will deplete the bankruptcy estate at the expense of unsecured creditors.\textsuperscript{114} However, mere appreciation in value of collateral should escape the preference net. Thus, for example, increases in the value of collateral resulting from the harvesting of crops, completion of work in process, generation of accounts receivable upon sale of inventory, and seasonal fluctuations in value of collateral would be protected unless the trustee succeeds in establishing that they caused an improvement in position to the detri-

\textsuperscript{113} 11 U.S.C. § 547(c)(5) (Supp. IV 1980). There seems to be some confusion as to the locus of the burden of proof under § 547(c)(5). One recent case holds that once the trustee has established a § 547(b) preferential transfer "the creditor has the burden of proving that it is protected by one of the exceptions." \textit{In re Ken Gardner Ford Sales, Inc.}, 10 Bankr. 632, 646 (Bankr. E.D. Tenn. 1981). Another case holds that the trustee has the burden of establishing every element of a preference, and that this burden requires the trustee to establish the requisite improvement in position under § 547(c)(5). \textit{In re The Music House, Inc.}, 11 Bankr. 139, 141 (Bankr. D. Vt. 1980). \textit{See also 4 COLLIER BANKRUPTCY PRACTICE GUIDE § 64.08[2][e], at p. 64-52 to 64-53 (1981).} Although § 547(c)(5) is silent on the point, an earlier version of the provision expressly stated that the "transferee has the burden of establishing that he has not improved his position under the rules above stated." \textit{NATIONAL BANKRUPTCY CONFERENCE, REPORT OF THE COMMITTEE ON COORDINATION OF THE BANKRUPTCY ACT AND THE UNIFORM COMMERCIAL CODE (1970)}, \textit{reprinted in House Report, supra} note 5, at 211 (proposed § 60a(4)(IV)). The drafters of this proposal apparently believed that the burden should be on the transferee to show no improvement because "presumably [the transferee] has all the relevant records." \textit{Id.}, at 216. The author of this article is not convinced that actual business practice justifies such an assumption.

\textsuperscript{114} \textit{See Young, supra} note 5, at 234.
ment of the estate.\textsuperscript{115}

Where the improvement in position is caused solely by market forces, such as in the case of gasoline reserves held by an oil company during a rising market, the trustee's preference attack should fail for two reasons. First, it is difficult to conceive of the increased value as constituting a "transfer of property of the debtor" as required of an avoidable preference by section 547(b)\textsuperscript{116}—assuming the gasoline was acquired by the debtor prior to the preference period, the mere fact that the gasoline has become more valuable during the ninety-day period does not appear to fit within the definition of transfer contained in section 101(40) of the New Act.\textsuperscript{117}

Second, even if we assume that the trustee can establish a section 547(b) transfer, the improvement in position caused by the additional market value of the pre-existing gasoline does not result in any depletion of the debtor's estate to the disadvantage of unsecured creditors.\textsuperscript{118}

However, where the increased value is caused, at least in part, by expenditures made by the debtor, such as in the case of completion of work in process, the question is a much more difficult one. Here, the trustee could argue that the expenditures made by the debtor during the preference period constitute section 547(b) preferential transfers of property of the debtor, and that, at least to the extent of such expenditures, the resulting improvement in position causes a


\textsuperscript{116} 11 U.S.C. § 547(b) (Supp. IV 1980). See White & Summers, supra note 10, at 1010-11; Clark, supra note 90, at 179-80.

\textsuperscript{117} 11 U.S.C. § 101(40) (Supp. IV 1980) defines the term "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.

Thus, although the initial acquisition by the debtor of the gasoline subject to the security interest is certainly a transfer, the subsequent increase in the value of that same gasoline does not appear to constitute a second transfer. See In re Nivens, 22 Bankr. 287, 293-4 (Bankr. N.D. Tex. 1982).

\textsuperscript{118} See White & Summers, supra note 10, at 1010. But see Note, supra note 42, at 254 (arguing that an unanticipated upward swing in value gives rise to a "classic windfall" which should be shared equally by all creditors).
depletion of the debtor's bankruptcy estate to the prejudice of unsecured creditors.\textsuperscript{119} Some commentators have suggested that all of the improvement resulting from such expenditures by the debtor, including any profits generated as a result thereof, should be avoidable by the trustee.\textsuperscript{120} Others have argued that, except perhaps in unusual cases, none of the increased value should be recovered for the benefit of the estate.\textsuperscript{121}

Perhaps the best solution to the problem is the compromise proposed by Professor Homer Kripke in a 1970 letter to the Gilmore Committee: the floating lienor may retain the entire value of the finished goods minus the costs expended by the debtor in finishing them.\textsuperscript{122} Professor Kripke's solution is more in accordance with the policy of section 547(c)(5), which attempts to strike a delicate balance between the interests of secured and unsecured creditors, than are the all-or-nothing propositions discussed above; it recognizes and protects the expectations of floating lien creditors\textsuperscript{123} up to the point where those expectations potentially cause a depletion in the debtor's estate during the preference period to the detriment of unsecured creditors. However, it is difficult to predict how the courts will handle these problems when confronted with the multitude of factual sit-

\begin{footnotesize}
\textsuperscript{119} The argument here is based on the somewhat optimistic assumption that had the expenditures not been made to complete the work in process, they would have remained unencumbered in the debtor's possession and thus available to unsecured creditors in bankruptcy. \textit{But see} Clark, \textit{supra} note 90, at 180 ("... it is playing with metaphysics to say that a "transfer" has occurred").

\textsuperscript{120} \textit{See} Kaye, \textit{supra} note 5, at 211; Macey, \textit{supra} note 5, at 701.

\textsuperscript{121} \textit{See} WHITE & SUMMERS, \textit{supra} note 10, at 1010-11; Clark, \textit{supra} note 90, at 180-81. \textit{Cf.} Hogan, \textit{supra} note 26, at 558-59.


\textsuperscript{123} When a creditor advances money secured by raw materials and half-finished products, there is an expectation that the goods will be completed and sold for value. Often when the security interest is created the collateral in the unfinished state is worth only a fraction of its potential value. To deny the creditor the benefit of the appreciation that was at the base of the bargain would be unfair. In addition, the other creditors are not unduly prejudiced by allowing the creditor the benefit of an increase that is consistent with ordinary business dealings.

\textit{Note}, \textit{supra} note 42, at 253 (footnotes omitted).
\end{footnotesize}
uations that could arise; it is to be hoped that the judges will apply the Kripke formula not only to goods which are in the manufacturing process at the beginning of the preference period, but also to raw materials, which are converted to finished products, and crops and cattle, which are cared for, fertilized, fattened, or harvested, during the ninety-day period.

iii. Application to Insiders

As discussed above, although in the typical case the initial date of calculation under the two-point improvement in position test is ninety days before bankruptcy, when the transferee is a statutory insider of the debtor different

124. Attempts have been made to distinguish goods which are raw materials at the beginning of the preference period from those which are already in process at such time. For example, the Commission on the Bankruptcy Laws of the United States appears to support the Kripke formula as to work in process, while favoring recovery by the trustee of the entire improvement resulting from conversion of raw materials into finished products during the preference period. See COMMISSION REPORT, supra note 115, at 209-10. See also Skilton, Security Interests in After-Acquired Property Under the Uniform Commercial Code, 1974 Wis. L. Rev. 925, 1008 (1974) (quoting from letter of Professor Kripke to Professor Skilton, dated October 9, 1974).

125. 11 U.S.C. § 101(25) (Supp. IV 1980) defines the term “insider” as follows:

“insider” includes
(A) if the debtor is an individual—
(i) relative of the debtor or of a general partner of the debtor;
(ii) partnership in which the debtor is a general partner;
(iii) general partner of the debtor; or
(iv) a corporation of which the debtor is a director, officer, or person in control;
(B) if the debtor is a corporation—
(i) director of the debtor;
(ii) officer of the debtor;
(iii) person in control of the debtor;
(iv) partnership in which the debtor is a general partner;
(v) general partner of the debtor; or
(vi) a relative of a general partner, director, officer, or person in control of the debtor;
(C) if the debtor is a partnership—
(i) general partner in the debtor;
(ii) relative of a general partner in, general partner of, or person in control of the debtor;
(iii) partnership in which the debtor is a general partner;
(iv) general partner of the debtor; or
(v) person in control of the debtor;
(D) if the debtor is a municipality, elected official of the debtor or relative of an elected official of the debtor;
rules apply. In fact, it will probably be necessary to make two separate deficiency calculations when an inventory or receivables floating lienor is an insider of the debtor.

Consider, for example, the following hypothetical. Suppose that one year before bankruptcy D owes SP, a statutory insider, $100,000 under a pre-existing loan secured by present and after-acquired inventory. On this date, SP has a perfected security interest in D’s inventory with a value of $10,000.126 Ninety days before bankruptcy D still owes SP $100,000; however, D has acquired additional inventory and the value of the collateral securing the loan is $80,000.127 Finally, on the date D files his bankruptcy petition, the outstanding balance of the loan remains $100,000, and the value of D’s inventory is $95,000.128 What is the extent of the trustee’s preference power on these facts?

The trustee will almost certainly be able to avoid SP’s security interest to the extent of $15,000. Furthermore, if the trustee is able to meet the additional burdens imposed by section 547 with respect to insider preferences made between ninety days and one year before bankruptcy, he or she may be able to further avoid SP’s security interest by as much as an additional $70,000. This solution requires two computations of improvement in position, and also raises complicated questions concerning the timing of transfers of SP’s perfected security interest in D’s inventory.

The first computation is a familiar one by now and should not require detailed explanation. It is a simple appli-

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

Since the term “insider” is defined inclusively, it is possible that other persons or entities having a close relationship with the debtor will be treated as insiders by the courts. See In re Montanino, 15 Bankr. 307 (Bankr. D. N.J. 1981); 4 COLLIER, supra note 30, ¶ 547.29.

126. Thus, the collateral deficiency as of this date is $90,000 ($100,000 debt minus $10,000 security). 11 U.S.C. § 547(c)(5) (Supp. IV 1980). See supra note 84.

127. Thus, the collateral deficiency as of this date has been reduced to $20,000 ($100,000 debt minus $80,000 security). 11 U.S.C. § 547(c)(5) (Supp. IV 1980). See supra note 84.

128. Thus, the collateral deficiency as of this date has been further reduced to $5,000 ($100,000 debt minus $95,000 security). 11 U.S.C. § 547(c)(5) (Supp. IV 1980). See supra note 84.
cation of the elements of a typical preference under section 547(b) and the ninety-day, two-point improvement test of section 547(c)(5). Since D acquired at least $15,000 worth of new inventory during the ninety-day preference period, and since the other elements of a preference appear to exist as to this collateral, the trustee should be able to recover the full amount of the $15,000 improvement arising between the ninety-day measuring point and the bankruptcy-day measuring point.

In addition, because SP is an insider, the trustee is also entitled to recover so much more of SP’s security interest as is avoidable under sections 547(b)(4)(B) and 547(c)(5)(A)(ii). Again, because section 547(c)(5) only operates after a section 547(b) preferential transfer has been established, the critical inquiry is how much of SP’s perfected security interest in D’s inventory is preferential under section 547(b)(4)(B)? No clear answer to this question is possible without more facts than were given in the hypothetical. The trustee will need to show, in addition to the usual elements of a preference, that the transfer was made “between 90 days and one year before the date of the filing of the petition,” and that SP was an insider who had “reasonable cause to believe the debtor was insolvent at the time of such transfer.” In addition, the trustee will be required to meet his burden of proving

129. Under the Bankruptcy Reform Act, transfers made to insiders during the normal 90-day preference period are treated the same as transfers made to other persons. See 4 COLLIER, supra note 30, ¶ 547.29.
131. The facts of the hypothetical assume that SP is an insider of D.
132. The “reasonable cause” requirement retained under the Bankruptcy Reform Act for insider preferences is basically the same element required of all preferences under the Former Act. See 4 COLLIER, supra note 30, ¶ 547.30. Although the “reasonable cause” requirement was all too frequently an insurmountable hurdle for the trustee under the Former Act, (see HOUSE REPORT, supra note 5, at 178), it should not prove to be a major difficulty under the New Act because the “special relationship of the debtor to the insider should make it relatively easy for the trustee to demonstrate that the insider-transferee had reason to know of the debtor’s insolvency.” Macey, supra note 5, at 702. See In re Montanino, 15 Bankr. 307 (Bankr. D. N.J. 1981). However, in at least two recent insider preference cases the trustee has failed to establish the reasonable cause to believe requirement. See In re Gruber Bottling Works, Inc., 16 Bankr. 348 (Bankr. E.D. Pa. 1982); In re Roco Corp., 15 Bankr. 813 (Bankr. D. R.I. 1981), aff’d in part and vacated in part, 21 Bankr. 429 (Bankr. 1st Cir. 1982).
that the debtor was insolvent at the time of the transfer unaided by section 547(f), which raises a presumption of insolvency only during the ninety-day period. If the trustee fails to meet any of these additional requirements, he or she has failed to show an avoidable insider preference and there is no need to resort to section 547(c)(5). For example, if D's inventory had completely turned over during the ninety-day period preceding bankruptcy, none of the inventory subject to SP's security interest at the time of bankruptcy would have been transferred "between 90 days and one year before the date of the filing of the petition." Alternatively, if the trustee is unable to prove that D was insolvent, or that SP had reasonable cause to believe that D was insolvent, at the time of any transfer shown to have been made during the


134. 11 U.S.C. § 547(b)(4)(B) (Supp. IV 1980). If we assume that D was insolvent at all times on and after the date one year before bankruptcy, and that SP had reasonable cause to believe that D was insolvent during such time, it becomes difficult to accept the conclusion that the trustee is limited to recovery of the $15,000 90-day improvement simply because the collateral completely turned over during the final 90 days before bankruptcy. However, such an interpretation is required by a literal reading of § 547(c)(5)(A)(ii), which gives the trustee the benefit of the one-year measuring point only with respect to insider transfers occurring between 90 days and one year before bankruptcy under § 547(b)(4)(B). 11 U.S.C. § 547(c)(5)(A)(ii) (Supp. IV 1980). And, since under the assumption the collateral completely turned over within the last 90 days before bankruptcy, none of SP's security interest in D's inventory was transferred during the one-year to 90-day insider preference period. 11 U.S.C. § 547(c)(3) (Supp. IV 1980). The results produced by such construction are inconsistent with sound bankruptcy preference policy. Section 547(b)(4)(B) is designed to provide additional protection to unsecured creditors against transfers to insiders, because insiders may be in a position to manipulate the affairs of the debtor in order to escape preference attack. For example, an insider might be able to cause the debtor to delay filing a petition in bankruptcy long enough to insure that a particular transfer benefiting the insider is outside of the normal preference period. See B. Weintraub & A. Resnick, supra note 80, ¶ 7.05[2][d]. Insider manipulation is even a greater problem in the context of floating lien financing, because the insider may also be able to control the timing of acquisition and disposition of collateral by the debtor. Moreover, the obvious intention of § 547(c)(5)(A)(ii) is to catch in the preference net the entire one-year improvement accruing to a floating lienor who is an insider with reasonable cause to believe that the debtor is insolvent. In this regard, it is hoped that the bankruptcy courts will be sensitive to the purpose, as well as the literal language, of § 547(c)(5), and interpret the section in a manner which permits the trustee to recover the entire amount of the one-year improvement for the benefit of the estate.
insider preference period, again there would be no section 547(b) preference. 135

However, if we assume that the trustee can demonstrate the elements of an insider preference under section 547(b), it is then necessary to make a second computation of improvement in position under section 547(c)(5). For example, assume the trustee establishes that $70,000 of the inventory subject to SP's security interest at the time of bankruptcy was acquired by D between ninety days and one year before bankruptcy, and that the trustee is otherwise able to meet his burden of establishing a section 547(b) insider preference. A second computation of improvement would now be necessary under section 547(c)(5) pursuant to which SP's collateral deficiency as of the date one year before bankruptcy would be compared to that existing on the date of the filing of the petition. 136 Under this analysis, SP has improved its position by $85,000 and the trustee would therefore be empowered to avoid SP's security interest in the entire $70,000 pool of inventory acquired during the insider preference period. 137 Thus, since the trustee is also entitled to avoid a $15,000 improvement under section 547(c)(5)(A)(i), 138 the total amount of the preference recovery would be $85,000.

137. Id. Again, since § 547(c)(5) does not give the trustee any affirmative avoidance powers, his or her recovery under § 547(c)(5)(A)(ii) can not exceed the amount of the insider preference established by § 547(b)(4)(B). See supra note 134 and accompanying text. To avoid the possibility of double liability being imposed upon the secured party in connection with the trustee's recovery of the insider period improvement, the collateral deficiency as of the date of bankruptcy should be recomputed following recovery of the $15,000 90-day improvement. Under this analysis, the $15,000 security interest avoided under § 547(c)(5)(A)(i) would be subtracted from the value of the collateral as of the bankruptcy-day measuring point before the insider period computation is made under § 547(c)(5)(A)(ii). This would result in a $70,000 revised improvement in position between the one-year measuring point ($100,000 debt minus $10,000 security equals a $90,000 collateral deficiency) and the bankruptcy day measuring point ($100,000 debt minus $80,000 [i.e. $95,000 − $15,000] security equals a $20,000 collateral deficiency). Cf. supra notes 107-112 and accompanying text. Notice that the hypothetical discussed in the text would not be affected by the suggested recomputation.
138. See supra note 129 and accompanying text.
iv. Intentional Buildups

Because section 547(c)(5) enacts an arbitrary two-point improvement in position test that ignores intervening fluctuations in the value of inventory and receivables collateral, there is potential for abuse by overreaching secured parties. Suppose, for example, that at the ninety-day measuring point D owes SP $100,000 secured by accounts with a value of $90,000. However, as D slides into insolvency accounts are paid more quickly than they are replaced; as a result, 30 days before bankruptcy the value of the accounts securing the $100,000 loan is only $25,000.139 When SP learns of D's predicament, it pressures D to rebuild the level of his accounts by foregoing payment of other debts and conducting a crash sale of inventory or other assets at less than market value. Finally, when D files a chapter 7 petition, he owes SP $100,000 and the value of the accounts is, once again, $90,000.140

Sound bankruptcy policy condemns the transaction described in the above hypothetical as a classic preference. However, it appears that the Bankruptcy Reform Act leaves the trustee powerless to take any action against it, because the amount of SP's collateral deficiency has not been reduced under the section 547(c)(5) two-point calculation. The collateral deficiency on each of the two calculation dates was $10,000 ($100,000 debt minus $90,000 security), and the intervening dip and intentional buildup in the size of the collateral are irrelevant.141

Clearly, this situation cries out for reform. Some com-

139. Typically, when a business begins to slip into insolvency, the level of its accounts deteriorates. See National Bankruptcy Conference, Report of the Committee on Coordination of the Bankruptcy Act and the Uniform Commercial Code (1970), reprinted in House Report, supra note 5, at 216.

140. See Hogan, supra note 26, at 565. To further complicate the problem, the preferred transferee might even be able to control the timing of the calculation of improvement by filing an involuntary petition under § 303 of the New Act. 11 U.S.C. § 303 (Supp. IV 1980). See Clark, supra note 90, at 178-79. Admittedly, the hypothetical situation will only rarely, if ever, occur in the real world. See White & Summers, supra note 10, at 881 (1972).

141. 11 U.S.C. § 547(c)(5) (Supp. IV 1980). The trustee may be able to attack this transaction under § 548 of the New Act as a transfer made by the debtor "with actual intent to hinder, delay or defraud" creditors. 11 U.S.C. § 548(a)(1) (Supp. IV 1980).
mentators have suggested that section 547(c)(5) be amended to limit its protection to inventory and receivables acquired in the ordinary course of the debtor's business.\textsuperscript{142} Although this suggestion has merit, it is a case of overkill and is certain to undermine the simplicity and administrative efficiency sought by the drafters of section 547(c)(5). No longer would the section be concerned primarily with an objective determination of improvement in the secured position of floating lienors; rather, it would focus chiefly on factual matters and would require endless litigation concerning the nature of the debtor's business and "the method, manner and terms of the debtor's acquisition of rights in the collateral."\textsuperscript{143} Moreover, because of the open-ended nature of an ordinary course of business requirement, these endless factual determinations could arise in every bankruptcy proceeding involving inventory and receivables collateral, and not merely in those where secured party manipulation is alleged.

Such a costly solution to a problem which is likely to occur in practice only rarely is unwarranted. A less complex, more direct approach is required. Denying protection under section 547(c)(5) to transfers of inventory and receivables made in bad faith is a preferable response to the problem of secured party manipulation. Obviously, such a solution would also result in litigation involving factual matters (i.e. the good faith of debtors and their secured financers); however, its narrow focus should confine these costly disputes to cases where secured party misconduct is alleged. Although Congress should consider amending section 547(c)(5) along these lines, the courts, if presented with an appropriate case, ought not to wait for legislation.\textsuperscript{144} See

---

\textsuperscript{142} See Note, supra note 42, at 255-57. Cf. \textsc{White & Summers, supra} note 10, at 881-82 (1972); \textsc{Hogan, supra} note 26, at 571-73. An earlier draft of what became § 547(c)(5) extended its protection only to inventory and receivables acquired or arising "in the ordinary course of a debtor's business." \textsc{National Bankruptcy Conference, Report of the Committee on Coordination of the Bankruptcy Act and the Uniform Commercial Code (1970), reprinted in House Report, supra} note 5, at 211 (proposed § 60a(4)(IV)). \textsc{See also} \textsc{U.C.C. § 9-108 (1972)}.\textsuperscript{143} See \textsc{Hogan, supra} note 26, at 571.

\textsuperscript{144} Support for imposing a good faith requirement on transfers of inventory and
cured party abuse of the protection accorded them by section 547(c)(5) is clearly outside the scope of the policy of that section, and a judicially imposed requirement of good faith is an appropriate response.

C. Evaluating the Compromise

Historically, preference law is rooted in the law of fraudulent conveyances. Under section 60(b) of the Former Act, these origins of preference law were manifested in the subjective requirement that the preferred creditor have reasonable cause to believe that the debtor was insolvent at the time of the transfer. The Bankruptcy Reform Act has shaped a policy that attempts to move beyond this historical development by adopting an approach to the preference problem that is both objective and purposive. One example of this development in the law of preferences under the Bankruptcy Reform Act is elimination in the typical case of the requirement that the transferee have reasonable cause to believe that the debtor was insolvent at the time of the transfer. Another example is section 547(c)(5) which, together

receivables protected by § 547(c)(5) is found in § 1-203 of the Uniform Commercial Code, which imposes an obligation of good faith on every contract and duty under the Code. U.C.C. § 1-203 (1972). Although § 1-203 of the Code is not part of the Bankruptcy Reform Act and therefore does not control bankruptcy questions, it supplies a useful analogy for a bankruptcy judge construing § 547(c)(5) in a case involving secured party misconduct. See Hogan, supra note 26, at 573.

145. See Jackson & Kronman, Voidable Preferences and Protection of the Expectation Interest, 60 Minn. L. Rev. 971, 977 (1976).
146. See supra note 132 and accompanying text.
147. Jackson & Kronman, supra note 145, at 979.
148. See 11 U.S.C. § 547(b)(4) (Supp. IV 1980). The "reasonable cause to believe" test is retained only with respect to preferential transfers made to insiders "between 90 days and one year before the date of the filing of the petition." Id. Elimination of this requirement in most cases is supportive of modern bankruptcy preference policy, because 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." House Report, supra note 5, at 178. See supra note 44.

However, certain critics of section 547 have argued unpersuasively that "the burden has been shifted too far and now unfairly discriminates against the good faith creditor." S. Rep. No. 446, 97th Cong., 2d Sess. 24 (1982). In response, the proposed Bankruptcy Improvements Act of 1982 contains language reinserting the fraud-based, subjective "reasonable cause to believe" test as an essential element of all avoidable preferences. S. 2000, 97th Cong., 2d Sess. § 11 (1982).
with section 547(e)(3), adopts an objective improvement in position solution to the problem of floating lien collateral attaching to pre-existing security interests during the preference period.\textsuperscript{149}

In formulating a preference policy concerning the floating lien, the drafters of the Bankruptcy Reform Act had two primary purposes. First, they sought to respond to the criticism that case law under the Former Act weighed "the scales much too heavily on the secured creditor's side."\textsuperscript{150} Their second objective, which was no less important than the first, was to devise a reasonably simple rule that would avoid complicated and expensive litigation of factual issues on a case by case basis.\textsuperscript{151} Careful analysis of the resulting legislative product, sections 547(e)(3) and 547(c)(5), indicates that, for the most part, both of these goals have been realized.

\begin{footnotesize}
\begin{enumerate}
\item[149.] 11 U.S.C. § 547(c)(5) (Supp. IV 1980).
\item[150.] NATIONAL BANKRUPTCY CONFERENCE, REPORT OF THE COMMITTEE ON COORDINATION OF THE BANKRUPTCY ACT AND THE UNIFORM COMMERCIAL CODE (1970), reprinted in HOUSE REPORT, supra note 5, at 208. As discussed above, cases decided under the preference rules of the Former Act afforded nearly absolute protection to the floating lien against the trustee's preference attack. See supra notes 20 to 39 and accompanying text. Taken together, §§ 547(e)(3) and 547(c)(5) overrule by inconsistency all of the major theories recognized by the courts under the Former Act. See HOUSE REPORT, supra note 5, at 374. The "Mississippi River" and "so far perfected" theories clearly do not survive passage of § 547(e)(3), because that section does not leave room for arguments that seek to relate the timing of a transfer back to a date prior to the debtor's acquisition of rights in the collateral. See Kaye, supra note 5, at 207-08; Nimmer, supra note 46, at 316-17. The few jurisdictions that appear to have held that under § 9-108 security interests in after-acquired collateral are not given for antecedent debt and therefore are not preferential ought to reconsider their position, both because of its infirmity under the supremacy clause of the United States Constitution and its inconsistency with the spirit of § 547(e)(3) and § 547(c)(5). See supra note 39 and accompanying text; Young, supra note 5, at 233. Finally, § 547(c)(5) is, in effect, a limited codification of the relaxed substitution theory, and any attempt to apply that theory more broadly than allowed under § 547(c)(5) would be contrary to the policy of such section. See Henson, supra note 10, at 18-19; Nimmer, supra note 46, at 319.
\item[151.] The policy . . . sacrifices a great deal to simplicity of administration. It seeks to avoid complicated and expensive litigation by focusing the judicial inquiry on the situation as it existed on the two dates chosen as measuring points.
\end{enumerate}
\end{footnotesize}
The foundation of sections 547(e)(3) and 547(c)(5) is the principle that preference law should seek to protect the interests of unsecured creditors of the debtor without undermining the reasonable contractual expectations of floating lien secured parties.\footnote{See Jackson & Kronman, supra note 145, at 976-77. It is just as essential that valid contractual expectations be protected in bankruptcy as in other settings. In this regard, Jackson and Kronman take the position that:}

If a trustee in bankruptcy were permitted to use his avoiding powers to nullify, without restriction, the priorities for which the bankrupt's secured creditors have bargained, the use of secured transactions as a financing device would be significantly chilled—perhaps frostbitten. Like contracts of other sorts, secured contracts embody a set of expectations that cannot be ignored without frustrating the very purpose such transactions are designed to serve. Obviously this result would be undesirable from the standpoint of secured creditors; but more importantly, it would also harm debtors by significantly restricting the availability of credit. \footnote{Id. at 988-89 (footnote omitted). However, a purposive analysis of § 547(c)(5) should not fail to consider that the improvement in position test was intended to rescue unsecured creditors from the perceived unfairness of case law under the Former Act giving near total protection against preference attack to the floating lien. See National Bankruptcy Conference, Report of the Committee on Coordination of the Bankruptcy Act and the Uniform Commercial Code (1970), reprinted in House Report, supra note 5, at 208.}

This requires a delicate balancing of state policies recognizing the commercial significance of inventory and receivables financing against federal bankruptcy policies designed to provide unsecured creditors equitable access to at least some of the assets of insolvent debtors.\footnote{See supra notes 40-49 and accompanying text.} The Bankruptcy Reform Act accomplishes this task by building a compromise solution around the following two premises: 1) that floating lien creditors reasonably expect to retain in bankruptcy a secured status equal to that held at the beginning of the preference period; and 2) that it is unreasonable for such secured creditors to expect to benefit from any improvement in this position, to the prejudice of unsecured creditors, during the ninety-day period preceding the debtor's financial collapse.\footnote{See Jackson & Kronman, supra note 145, at 976.} The first assumption acknowledges the need to minimize conflict between bankruptcy preference law and the provisions of the Uniform Commercial Code recognizing the commercial significance of, and giving effect to, extensions of credit secured by property to
be acquired in the future. The second assumption recognizes the precarious position in bankruptcy of the class of unsecured claimants, which is made to shoulder the greatest burden of the debtor's financial collapse, and attempts to minimize the social costs of the bankruptcy process by making available at least a small portion of the debtor's assets to these least fortunate of creditors.

Of course, the actual expectations of floating lienors are probably not in accord with those assumed immediately above. Floating lien secured parties expect to receive what they bargained for—all present and subsequently acquired property of the debtor as described in the security agreement between the parties. Moreover, they and their champions reason that unsecured claimants, who chose to extend credit without taking security and with notice of all filed financing statements evidencing outstanding security interests, have no equitable claim to avoid enforcement of valid security agreements in accordance with their terms.

156. Every bankruptcy contains within itself the seeds of others, of a chain of failed enterprise radiating throughout the economy. To guard against this danger, which threatens all classes of creditors—indeed, all participants in the economy—the trustee is empowered to avoid the contractual rights of the bankrupt's secured creditors in certain limited cases; by doing so, he can increase that portion of the bankrupt's estate which will be applied to satisfy the claims of general unsecured creditors.
157. See id at 977, 998-1000.
158. It is commonly said that "equality is equity" in bankruptcy. What is "equality"? What is "equity"? The concept of equality seems almost Orwellian: all are equal, but some are more equal than others. Those who were prudent enough to take security are reduced to the level of those who did not, so that the ever-rising costs of administration tend to make distributions to creditors approach zero. It would in fact, on the average, make almost no difference to unsecured creditors if all secured transactions were set aside in bankruptcy, but it would make a considerable difference to the secured parties involved. Is it "equity" to frustrate the legitimate agreements of the parties to a secured transaction? It may seem equitable to unsecured creditors to do so, but they extended credit when they could easily have refused or else taken security, and the financing statement evidencing a "prior" claim to the debtor's assets was a matter of public record.

Henson, "Proceeds" Under the Uniform Commercial Code, 65 Colum. L. Rev. 232, 252-53 (1965) (footnotes omitted). Professor Viles, a champion of the unsecured creditor, has stated the counterpoint:

To whom is the [filed financing] statement sufficient? Inasmuch as the New
However, in most cases the balance struck by section 547(c)(5) appears to be a fair and rational balancing of the competing interests—floating lien creditors receive the full benefit of their secured status as it existed ninety days before bankruptcy, and unsecured creditors are not prejudiced as a result of any gains made by floating lienors during the debtor's slide into bankruptcy. Moreover, inventory and receivables creditors can insure total protection of their after-acquired collateral by inserting (and policing) provisions in their loan documentation that require the loans to be adequately secured at all times.\footnote{159}

Assuming that questions of valuation do not prove to be overly complicated and time consuming,\footnote{160} the New Act also appears to have realized its second objective by enacting a simple, utilitarian solution to the problem of the floating lien in bankruptcy. Section 547(e)(3) provides a clear rule for determining the timing of transfers of after-acquired collateral,\footnote{161} and, in the typical case, section 547(c)(5) limits the focus of the judicial or administrative inquiry to two questions of fact—the amount of the collateral deficiency at each of the two measuring points.\footnote{162}

However, it is difficult to devise a simple solution to a broad-based problem, and some commentators have argued that the two-point rule is capable of producing arbitrary and unfair results in certain hypothetical situations.

\footnote{Righteousness of the secured creditor rests heavily on the Code's system of notice-filing, which purports to overcome the fraud of secret liens, this is an especially pertinent question. Is it adequate warning to a potential bankrupt's employees, small-time suppliers, and casual vendors? Can any kind of filed notice justify omitting them entirely or almost entirely from the bankruptcy distribution? As total security becomes widespread the logical alternatives to taking the risk will reduce to one alternative: ceasing altogether to be a small-time supplier, an employee, or a casual vendor. . . . The likeliest party to benefit under the Code notice requirements is the security-conscious financer who needs to know whether another financer has already taken a (maximum) security interest in the property of a proposed debtor.}


\footnote{159. See supra notes 96-98 and accompanying text.}
\footnote{160. See supra note 91; Clark, supra note 90, at 178.}
\footnote{161. See supra notes 67-71 and accompanying text.}
\footnote{162. See Hogan, supra note 26, at 554.}
One such problem area, intentional buildups of collateral occurring during the period between the two measuring points, has already been discussed in this article. 163 A second source of concern among some of the analysts involves application of section 547(c)(5) to cyclical businesses and their inventory and receivables financiers. These critics argue that industries which do not have a constant flow of accounts or inventory, such as toy manufacturers, suppliers of recreational items and other seasonal businesses, may experience difficulty in obtaining secured credit, because the two-point rule may operate to deny protection to secured creditors who rely on seasonal increases in the value of their collateral. 164

Although this criticism is valid in theory, it appears to be an unavoidable by-product of the utilitarian goals of the drafters of the New Act, who were willing to accept arbitrary results in certain unusual cases in order to obtain the desired simplicity of administration in the great majority of cases. 165 Moreover, it has not been demonstrated to be a serious practical problem. For example, it is unlikely that a seasonal business will fail while at the top of a business cycle. 166 Furthermore, it may be possible for imaginative commercial lawyers to draft around the problem in many cases, perhaps by incorporating into security agreements additional policing requirements designed to insure that funds are not advanced against seasonal collateral unless and until they are adequately secured. Seasonal collateral financiers should also consider the possibility of further securing their loans

163. See supra notes 139-144 and accompanying text.
164. See, e.g., Aaron, The Bankruptcy Reform Act of 1978: The Full-Employment-For-Lawyers Bill: Part IV: Avoiding Powers of the Trustee, 1980 Utah L. Rev. 19, 50; Hogan, supra note 26, at 564-65; Kronman, supra note 24, at 146-47. Thus, for example, “the rule could penalize creditors of a business that has a cyclical flow of inventory; if the low point happened to fall ninety days before bankruptcy, such creditors could be hurt by the ‘bright line’ established in the rule.” Clark, supra note 90, at 179.
with other types of property owned by the debtor, such as business equipment or fixtures. Section 547(c)(5) works very well in most cases most of the time, and amendment of the provision to deal with the problem of seasonal collateral should be considered only as a last recourse, and not before it has been empirically demonstrated that there is a serious problem in commercial reality.

IV. CONCLUSION

Case law under the Former Act provided nearly absolute protection to perfected security interests attaching to collateral during the preference period pursuant to after-acquired property clauses in valid pre-existing security agreements. The Bankruptcy Reform Act replaced this case law with a legislative compromise that first treats most, if not all, security interests attaching to after-acquired collateral within ninety days of bankruptcy as preferences, and then exempts from preference attack security interests in inventory and receivables collateral to the extent that the floating lien financer has not improved its secured position at the end of the ninety-day period.

Although section 547(c)(5) is capable of complex applications, it is, in general, an efficient and workable response to the perceived unfairness of the case law under the Former Act. This article has discussed certain factual situations which, when analyzed under section 547(c)(5), may produce results not clearly in accord with fundamental notions of bankruptcy preference policy. However, purposive construction of section 547(c)(5) by the courts and creative lawyering by counsel for floating lien financers could eliminate most, if not all, of these difficulties. Finally, the article suggests that Congress consider amending section 547(c)(5) by adding a good faith requirement designed to eliminate potential secured party abuse of the two-point improvement in position test.