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The Impact of Section 547 of the Bankruptcy Code upon Secured and Unsecured Creditors

Thomas Ross*

Drafters of a new statute inevitably speculate about its future impact. These speculations in turn lead to assumptions that ultimately become the premises of the argument by which the statute will be justified. Once a statute is enacted, however, the first wave of criticism is commonly based on counter-speculation. Some critics may argue that the drafters failed to anticipate all the effects of the statute and that the effects they overlooked will be undesirable. Other critics may contend that the assumed effects, although desirable, will not materialize.

It is difficult for both drafters and critics to accurately predict the impact of a new statute, however, because its effects will inevitably be determined by the environment in which it operates. A statute's effects depend in large part on the meaning given its language. Courts may interpret or apply a statute in ways not foreseen by its drafters, resulting in unexpected effects. In addition, individuals affected by the statute may react

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* Associate Professor of Law, University of Pittsburgh School of Law. I am indebted to Professor Dennis R. Honabach for his thoughtful commentary on an earlier draft of this Article.

1. In re Harter, 10 Bankr. 272 (Bankr. N.D. Ind. 1981), provides an apparent example of judicial interpretation that is contrary to the drafters' intended meaning. Section 541 of the Bankruptcy Reform Act of 1978 (the "Code"), 11 U.S.C. § 541 (1982), defines the bankruptcy estate. With some exceptions not relevant here, § 541(a) includes in the bankruptcy estate "all legal or equitable interests of the debtor in property as of the commencement of the case." 11 U.S.C. § 541(a)(1) (1982). Thus, § 541 "includes as property of the estate all property of the debtor, even that needed for a fresh start. After the property comes into the estate, then the debtor is permitted to exempt it. . . ." S. REP. No. 999, 95th Cong., 2d Sess. 82, reprinted in 1978 U.S. CODE CONG. & AD. NEWS 5787, 5868. The Harter court, after quoting the above legislative history, held that the debtor's army retirement benefits were not part of the § 541 "estate," reasoning that the benefits were, in effect, future wages and therefore not property in which the debtor had an interest under § 541(a)(1). Yet, the statutory provision concerning future wages (not cited by the court) excludes "earnings from services performed by an individual debtor after the commencement of the case." 11 U.S.C. § 541(a)(6) (1982) (emphasis added). The pension benefits did not fit within the language of the statutory exclusion. Apparently, the court
by changing their behavior in ways not anticipated by the statute’s drafters. Finally, the values of the society in which the statute operates may evolve, and this too may affect the statute’s operation.

This Article examines a statutory provision in its youth—section 547 of the Bankruptcy Reform Act of 1978. In particular, it will consider the effect of section 547 on inventory and accounts receivable financing. The drafters of section 547 and concluded that the benefits were essential to the debtor’s fresh start and, because they could not be exempted, used the concept of “property” to enable the debtor to keep his benefits, notwithstanding the statutory language and legislative history.

2. For example, professionally counseled taxpayers may adjust their behavior annually to avoid the intended revenue effects of various tax statutes. The story of the “floating lien” of article 9 of the Uniform Commercial Code, a central concept of this Article, may provide another example. Under article 9, a creditor may, in theory at least, take a security interest in all of the debtor’s property, then owned or thereafter acquired, to secure all loans by the creditor, then made or thereafter advanced, pay no further attention to the debtor’s affairs, and be assured of a priority position in the debtor’s property should the debtor subsequently default. The “floating lien” of article 9 was intended to facilitate commercial transactions and to simplify the hodgepodge of pre-article 9 personal property security law. The principal drafter of article 9, Professor Grant Gilmore, hoped, and expected, that creditors would not encumber excessively the debtor’s property with this easy-to-attach “floating lien” and that creditors would continue to monitor the business health of the debtor. See I G. GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY § 11.7, at 359-65 (1965) [hereinafter cited as GILMORE, SECURITY INTERESTS]. Sixteen years later, Professor Gilmore concluded that creditor behavior had thwarted his expectations. In his view, secured creditors had used article 9 to tie up all of the debtor’s assets and to deny unsecured creditors anything more than a pittance in bankruptcy. See Gilmore, The Good Faith Purchase Idea and the Uniform Commercial Code: Confessions of a Repentant Draftsman, 15 GA. L REV. 605, 625-29 (1981) [hereinafter cited as Gilmore, Confessions of a Repentant Draftsman].


4. 11 U.S.C. § 547 (1982). Section 547 provides:

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

   (b) Except as provided in subsection (c) of this section, the trustee may avoid any transfer of property of the debtor—
some of its early critics assumed that it would affect the pattern of distributions to creditors in bankruptcy. Specifically,

(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.

(c) The trustee may not avoid under this section a transfer—
(1) to the extent that such transfer was—
(A) intended by the debtor and the creditor to or for whose benefit such transfer was made to be a contemporaneous exchange for new value given to the debtor; and
(B) in fact a substantially contemporaneous exchange;
(2) to the extent that such transfer was—
(A) in payment of a debt incurred in the ordinary course of business or financial affairs of the debtor and the transferee;
(B) made not later than 45 days after such debt was incurred,
(C) made in the ordinary course of business or financial affairs of the debtor and the transferee; and
(D) made according to ordinary business terms;
(3) of a security interest in property acquired by the debtor—
(A) to the extent such security interest secures new value that was—
   (i) given at or after the signing of a security agreement that contains a description of such property as collateral;
   (ii) given by or on behalf of the secured party under such agreement;
   (iii) given to enable the debtor to acquire such property; and
   (iv) in fact used by the debtor to acquire such property; and
   (B) that is perfected before 10 days after such security interest attaches;
(4) to or for the benefit of a creditor, to the extent that, after such transfer, such creditor gave new value to or for the benefit of the debtor—
(A) not secured by an otherwise unavoidable security interest; and
(B) on account of which new value the debtor did not make an otherwise unavoidable transfer to or for the benefit of such creditor;
(5) 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 for such debt on the later of—
they supposed that the trustee in bankruptcy would use section 547 to avoid security interests in inventory and accounts receivable. It was hoped that these assets would become a source of enhanced bankruptcy distributions to unsecured creditors. This assumption, however, proved to be mistaken.

5. See H. R. REP. NO. 595, 95th Cong., 1st Sess. 179, 204-19, reprinted in 1978 U.S. CODE CONG. & AD. NEWS 5963, 6164-79 (REPORT OF THE COMMITTEE ON COORDINATION OF THE BANKRUPTCY ACT AND THE UNIFORM COMMERCIAL CODE) [hereinafter cited as COMMITTEE REPORT]. The Committee, responsible for the initial draft of what was to become § 547, characterized its effort as a "rescue mission for unsecured creditors." Id. at 208, 1978 U.S. CODE CONG. & AD. NEWS at 6168. See also Jackson & Kronman, Voidable Preferences and Protection of the Expectation Interest, 60 MINN. L. REV. 971 (1976); Kronman, The Treatment
Creditors with perfected security interests in inventory or accounts have little to fear from the potential application of section 547. The assumed change in bankruptcy distributions has not occurred, and probably will not. If anything, section 547 has exacerbated the plight of the unsecured creditor in bankruptcy. A review of the evolving case law will demonstrate the error in the assumption, as will a consideration of commercial practices and bankruptcy principles.

This Article consists of four parts. Part I discusses the nature and evolution of the basic assumption. Part II reviews the evolving case law under section 547. Part III discusses certain commercial practices and bankruptcy principles that undercut the basic assumption. Finally, this Article concludes that although section 547 is based on a mistaken assumption, for the reasons discussed it should not be amended.

I. THE NATURE AND EVOLUTION OF THE BASIC ASSUMPTION

A thorough retelling of the history underlying the drafting of section 547 would be duplicative and unnecessary; certain...
pieces of the story, however, must be understood. In 1966 the National Bankruptcy Conference established a Committee on Coordination of the Bankruptcy Act and the Uniform Commercial Code (the "Committee"). As a part of the redrafting of the bankruptcy act, the Committee considered the treatment of security interests in real and personal property in the bankruptcy context.

The Committee could have addressed the treatment of security interests in bankruptcy in a straightforward way, describing affirmatively which security interests would be honored in bankruptcy. Instead, the Committee chose to focus on the voidable preference concept which had become, under the existing law, "the principal conduit for discussion of the extent to which security interests were (or should be) good against or voidable by the trustee in bankruptcy." Thus, the Committee chose to redraft the voidable preferences section of the proposed bankruptcy act, the section that was eventually enacted as section 547.

Preference law, a feature of both the old bankruptcy act (the "Act") and the new bankruptcy code (the "Code"), is premised on the notion that certain transfers of debtors' property from debtors to creditors within a specified period of time prior to the filing of a bankruptcy petition may be undone in bankruptcy. A creditor who has received a preferential transfer must return the property transferred or its value to the bankruptcy estate, where the recaptured property becomes avail-

Current Law and Proposed Changes, 11 U.C.C. L.J. 95, 105 (1978); Jackson & Kronman, supra note 5, at 971-76.


8. COMMITTEE REPORT, supra note 5 at 204, 1978 U.S. CODE CONG. & AD. NEWS at 6164.

able for distribution to creditors generally.10

Traditionally, preference law has been justified by several policies.11 First, it facilitates a more equal distribution of the debtor’s property. Second, it discourages the dismemberment of ailing, but salvageable, debtors. When creditors are grabbing for their piece of a debtor, a debtor's recovery can be foreclosed. The specter of preference discourages grabbing and facilitates a debtor’s recovery.12 Finally, preference law enhances bankruptcy distributions to creditors as a group. This mitigates the financial loss to creditors and thereby reduces the social costs of bankruptcy.13 These standard justifications, although questionable, have nonetheless carried the day.14

Preference law thus formed the framework for the Committee’s debate. The Committee had to determine the extent to which secured creditors would be vulnerable to preferential avoidance of their security interests. In 1970 the Committee issued its final report and final draft of the proposed preferences

12. Although dismemberment is deemed undesirable in the preference analysis, the same phenomenon by another name is touted as desirable in a different commercial context. Prior to the enactment of article 9, creditors with security interests in a debtor’s accounts were required to “police” the debtor pursuant to the rule of Benedict v. Ratner, 268 U.S. 353 (1925). To “police” effectively under the Benedict rule, the creditor had to exercise some dominion over the accounts and proceeds of the accounts. For example, a creditor typically might require that all proceeds be remitted to the debtor. This policing gave the creditor a vantage point from which to discern early on the debtor’s financial distress. After concluding that a debtor is in trouble, the creditor could either engage in a salvage operation or demand repayment of the loan. Demanding repayment typically would drive the debtor into bankruptcy. Although this is a form of dismemberment, some have argued that “pulling the plug” on debtors in this manner is desirable. The financially distressed debtor typically piles up ever-increasing unsecured debt as it slides into bankruptcy. Pulling the plug sooner rather than later stops the accumulation of unsecured (and ultimately unpaid) debt. See 1 Gilmore, Security INTERESTS, supra note 2, § 8.3, at 257-61.
13. See Jackson and Kronman, supra note 5, at 989-90; McCoid, supra note 9, at 261.
14. See generally McCoid, supra note 9. Although preference law was historically aimed at preventing fraud, § 547 (both in its earlier drafts and as enacted) does not require fraudulent intent on the part of the debtor or the creditor. The rationales offered include assuring equality in the distributions to creditors, increasing the bankruptcy estate and thereby lessening the blow to the creditors as a group, and discouraging the “dismemberment” of the debtor on the eve of bankruptcy. This Article does not address the persuasiveness or accuracy of these general rationales.
Although the specific language of section 547 bears little resemblance to the Committee's original draft, section 547 does carry forward the Committee's basic approach. Thus, to understand the purposes and assumptions underlying section 547, it is necessary to understand the Committee's perspective.

When the Committee was empaneled, the validity of security interests in personal property in the bankruptcy context was uncertain. The law of security interests in personal property was embodied in article 9 of the Uniform Commercial Code. The existing bankruptcy law was erected by reference to the pre-article 9 system of security law. Although article 9 adopted most of the basic principles of the pre-Code security law, it differed in one important respect. Article 9 explicitly validated the "floating lien," a lien that covers property to be acquired by the debtor in the future ("after-acquired property") and secures loans to be made by the creditor in the future ("future advances"). Commentators suggested that the article 9 floating lien, particularly as it relates to after-acquired property, was wholly vulnerable to a trustee's attack under the Act's preference provisions. Under this interpretation, a security interest in the after-acquired property was deemed a "transfer" to the creditor as of the time of the debtor's acquisition of the property. If this transfer occurred within the preference period, the trustee might avoid the transfer resulting in the loss to the creditor of its security interest in the property. Thus, security interests in all property acquired by the debtor within the preference period, the four months preceding the bankruptcy filing, might be undone.

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15. COMMITTEE REPORT, supra note 5, at 204, 1978 U.S. CODE CONG. & AD. NEWS at 6164.
16. All references to the Uniform Commercial Code, unless otherwise indicated, are to the 1978 Official Text and Comments. The definitive work on the history, drafting, and philosophy of article 9 is Professor Grant Gilmore's two-volume work, SECURrrY INTERESTS IN PERSONAL PROPERTY, supra note 2. For an ongoing analysis of article 9 as it has evolved, see P. COOGAN, W. HOGAN, D. VAGTS & J. McDONNELL, SECURED TRANSACTIONS UNDER THE UNIFORM COMMERCIAL CODE (1983).
17. "Article 9 is not so much a new start or a fresh approach as it is a reflection of work long since accomplished." 1 GILMORE, SECURITY INTERESTS, supra note 2 § 9.1, at 290.
18. See U.C.C. § 9-204; 1 GILMORE, SECURITY INTERESTS, supra note 2 § 11.7.
21. Under the old Act, a preferential transfer was avoidable by the trustee only if the creditor, at the time of the transfer, had reasonable cause to believe that the debtor was insolvent. Thus, a trustee who was unable to make the
This specter was particularly frightening to creditors holding security interests in the debtor's inventory or accounts receivable. Inventory and accounts receivable by their nature are constantly fluctuating—inventory is sold and replaced with new inventory, accounts are paid, and new ones arise. Conceivably, all of a debtor's inventory or accounts could arise within the four months preceding a bankruptcy filing. In that event, the trustee might avoid the creditor's entire security interest, relegating the creditor to the status of a general, unsecured creditor, who typically receives a mere pittance in bankruptcy.

Several opinions in the late 1960's and early 1970's, however, gave solace to the secured creditor. These cases upheld the floating lien and its after-acquired property clause in bankruptcy preference attacks. The most expansive and noted case is DuBay v. Williams. The relevant creditor in DuBay had a perfected security interest in the debtor's accounts. Although most, if not all, of the accounts arose within the preference period, the court upheld the security interest. The DuBay court reached this result by interpreting a part of the preference section of the Act. Section 60a(2) of the Act provided that "a transfer of property . . . shall be deemed to have been made or suffered at the time 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 reasonable cause" showing would not be able to avoid the creditor's security interest, even as to after-acquired property. Bankruptcy Act of 1898, ch. 541, 30 Stat. 544, amended by Chandler Act, ch. 575, § 1, 52 Stat. 669 (1938) (repealed 1978). See infra text accompanying notes 62-64.

22. See Kronman, supra note 5, at 119.


rights of the transferee." Under article 9 a secured creditor with a perfected "floating lien" on a debtor's accounts has priority over subsequent lien creditors. The DuBay court therefore concluded that the "transfer," for preference analysis purposes, occurred at the moment of perfection, even though the relevant accounts did not exist at the moment of perfection. The DuBay interpretation, if carried to its logical extreme, would have insulated all article 9 interests in after-acquired property from preferential avoidance. As the Committee reported, "If the Ninth Circuit's DuBay opinion, read in the manner suggested, is to be taken as the end of the matter, secured parties can take blanket liens on all the present and future personal property of their debtors, make no further advances and sleep peacefully in the assurance that, on bankruptcy day, all the assets will come to them."  

Concluding that DuBay overly protected the interests of secured parties, the Committee sought to create an intermediate position that would give some protection to the expectation interest of the secured creditor and yet result in some level of avoidance, thereby providing a measure of meaningful relief to unsecured creditors. Focusing on security interests in inventory and accounts receivable, "the heart of the matter," the Committee created a position that combined a "two point measurement system" with an "improvement of position" test:  

What has been referred to as a "two point measurement system" is set up. The two measuring points are (1) four months before the date of filing the bankruptcy petition and (2) the date of filing. If the transferee is better off ("has improved his position") on the second date than he was on the first date, there is, pro tanto, a preference. "Improvement of position" is defined as the reduction of a deficiency or its conversion into a surplus between the two dates.

26. Professor Countryman referred to Judge Hufstedtler's interpretation as the "abracadabra" theory. Countryman, supra note 19, at 277.  

27. COMMRRrMEE REPORT, supra note 5, at 208, 1978 U.S. CODE CONG. & AD. NEWS at 6168.  

28. The Committee noted: The Ninth Circuit's analysis of the problem in DuBay weights the scales much too heavily on the secured creditor's side, just as much of the earlier analysis in the law review literature put too much weight in the opposite scale. The prospects for working through to an intermediate position between the two extremes through a case law development do not appear to be particularly bright. If a fair and sensible resolution of the underlying policy issues is available, as the Committee believes it is, a statutory revision is indicated.  

Id. at 208-209 (The above-quoted portion of the COMMITTEE REPORT is omitted from 1978 U.S. CODE CONG. & AD. NEWS.)  

29. Id. at 215, 1978 U.S. CODE CONG. & AD. NEWS at 6175.  

30. Id. at 216, 1978 U.S. CODE CONG. & AD. NEWS at 6176.
A "deficiency" exists to the extent that the outstanding indebtedness exceeds the value of the collateral at the relevant measuring points. For example, if four months prior to filing, the debtor's outstanding indebtedness to a creditor is $10,000 and the value of the collateral securing that indebtedness is $5,000, there is a $5,000 deficiency. If, on the filing date, the debt is $10,000 but the value of the collateral is $7,500, the deficiency is only $2,500. Using the "improvement of position" test, the $2,500 improvement is deemed a preference; the trustee may avoid the creditor's security interest in $2,500 worth of the collateral. Presumably, the Committee hoped this approach would reasonably protect the expectations of secured creditors and yet would result in some significant incidences of avoidance that would inure to the benefit of unsecured creditors.

Section 547(c)(5) of the new bankruptcy code, the subsection that speaks to the inventory and accounts problem, adopts the basic ideas underlying the "improvement of position" test of the Committee draft. Some modifications, however, did occur. The language has changed—the phrase "reduction of deficiency" is substituted for "improvement of position." The preference period is reduced from four months to ninety days for most cases. One prerequisite for a preferential transfer, that the creditor reasonably believe the debtor was insolvent at the time of the transfer, is eliminated. An additional prerequisite is present—the preferential transfers must be "to the prejudice of other creditors holding unsecured claims." Nonetheless, the subsequent drafters and Congress apparently did not intend any significant substantive change in the basic approach suggested by the Committee. Presumably, the idea of the intermediate position, giving something to the unsecured creditors as well as to the secured creditors, tagged along as well.

Legal scholars have approached the new preference law from two basic perspectives. First, some commentators have

31. "The term 'deficiency' means the amount by which the debt secured exceeds the aggregate value of the inventory, receivables, or proceeds which are collateral for the debt." Id. at 211, 1978 U.S. CODE CONG. & AD. NEWS at 6171.
33. Id.
35. See, e.g., Breitowitz, Article 9 Security Interests as Voidable Preferences
unwrapped the statute, explaining the statutory provisions in terms of both the simple hypotheticals in which the statute works quite easily and the more complex hypotheticals in which the statute works less well.\textsuperscript{36} Second, other commentators have explored the prescriptive question whether the preference provisions ought to have been constructed as they were.\textsuperscript{37} This latter approach focuses on the balance struck between the partial undoing of secured parties' expectations as against the concern for the unsecured creditors and the social costs of bankruptcy.\textsuperscript{38} Each perspective, however, carries forward the basic assumption of the Committee that the new preference law will in fact result in the avoidance of some significant level of security interests in inventory and accounts receivable.\textsuperscript{39} Debate has focused on whether this avoidance is desirable.

The drafters, Congress, and the commentators all seem to assume, either explicitly or implicitly, that section 547 would redistribute assets in some degree from inventory and accounts secured creditors to unsecured creditors. Yet, evolving case law under section 547 provides no support for this assumption.

\begin{itemize}
\item See, e.g., Duncan, supra note 35, at 23-29.
\item See, e.g., Jackson \& Kronman, supra note 5; McCoid, supra note 9.
\item See id. at 1001 ("The 'two-point net improvement test' adopted in the preference section of the proposed Act treats the secured party's expectation interest less generously than did the old Act.").
\item See, e.g., Duncan, supra note 35, at 45 ("[Section 547's application to security interests in inventory and accounts] has not been demonstrated to be a serious practical problem.").
\end{itemize}
Moreover, certain commercial practices and bankruptcy principles undercut this assumption.

II. THE EVOLVING CASE LAW UNDER SECTION 547

Although the new Code has been in effect for almost five years, and the interpretation and application of section 547 has been part of hundreds of bankruptcy court decisions, section 547 has apparently to date never been used to avoid security interests in inventory or accounts receivable. It does not necessarily follow from this observation that section 547 has had no impact on inventory and accounts receivable lenders. It is, however, an observation worth exploring.

Drawing conclusions from litigated cases is risky. Moreover, considering the typical life span of federal bankruptcy statutes, the Code is still in its youth. Nonetheless, the maturing process has been accelerated by an interesting, contemporaneous phenomenon. Along with the enactment of the new federal bankruptcy scheme, the volume of bankruptcy filings has increased enormously over the past several years. This avalanche of bankruptcy filings has swamped the docket of the bankruptcy courts and has pushed bankruptcy cases into the federal court system at an unexpected pace and volume. Thus, the litigated cases to date may reflect a Code older than its years.

Although inventory and accounts lenders have not been the target of section 547 litigation, section 547 is being used against creditors with other sorts of article 9 security interests. Trustees are using section 547 to undo the security interests of careless creditors who fail to perfect their security interests promptly. The careless secured creditor scenario arises in the

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41. See 2 GILMORE, SECURITY INTERESTS, supra note 2, § 45.1, at 1282-83 n.3. Professor Gilmore noted the comprehensive bankruptcy law revisions of 1898 and 1938 and correctly predicted in 1965 that the next comprehensive revision, "if the old schedule is adhered to," would occur in 1978. Id.
42. COMPTROLLER GENERAL, REPORT TO THE CHAIRMAN, HOUSE COMM. ON THE JUDICIARY 2-3 (1983) (noting that approximately 450,000 debtors filed bankruptcy in statistical year 1982, compared to approximately 197,000 personal bankruptcy filings in statutory year 1979).
43. The West Publishing Company's BANKRUPTCY REPORTER, which began publication of selected bankruptcy cases in the latter part of 1979, had published 35 volumes by the beginning of 1984.
following manner. Secured creditors who perfect their security interests at the time they extend value to the debtor receive a transfer of property, the security interest in the collateral, from their debtor. This transfer, however, is not on account of an antecedent debt, an essential element of any preferential transfer; rather, the transfer results because of the contemporaneous extension of value to the debtor. Because the necessary filing or other act of perfection is often most sensibly done after the extension of credit, the Code builds in a ten-day grace period—perfection within ten days after the extension of credit is deemed to be a transfer contemporaneous with the extension of credit and not a transfer on account of an antecedent debt. If, however, the creditor perfects after expiration of the grace period, the transfer is on account of the antecedent debt. A tardily perfected security interest is thereby rendered vulnerable under section 547.

*In re Davis* provides an example of the typical, careless secured creditor falling prey to section 547. The debtor purchased a piece of equipment and executed a “Retail Installment Contract” embodying the obligation on the unpaid portion of the purchase price and the security interest in the equipment to secure the obligation. The creditor filed a financing statement, perfecting the security interest in the equipment. Unfortunately, the filing did not occur until twenty days after the creation of the security interest, because the creditor’s employee in charge of filing financing statements was on vacation. In the subsequent bankruptcy proceeding, which was commenced within ninety days of the filing of the financing statement, the trustee avoided the transfer of the security interest, thus relegating the creditor to the status of a general unsecured creditor.
Other acts of carelessness on the part of secured creditors have included filing locally only and not with the central office,\textsuperscript{51} failing to take account of the debtor's change of business location, thereby rendering a timely filing ineffective,\textsuperscript{52} and simply failing to make a timely filing.\textsuperscript{53} Creditors lending against automobiles seem particularly prone to error, perhaps due in part to the vagaries of the various state departments of motor vehicles.\textsuperscript{54}

Inventory and accounts lenders seem to be a more careful lot, perhaps because of the substantial sums of money often at stake in this sort of lending. Nonetheless, \textit{In re Ken Gardner Ford Sales, Inc.}\textsuperscript{55} suggests there are exceptions. The creditor financed the debtor-auto dealer's acquisition of inventory over a ten-year period. The outstanding debt usually ranged between one and three million dollars. The creditor maintained a perfected security interest in the debtor's inventory. At the time of debtor's bankruptcy the outstanding indebtedness was $1,921,833.06, presumably fully secured by inventory of at least that value. Unfortunately, the creditor had paid a filing tax in connection with the financing statement that reflected only $1,250,000 in debt. Under the relevant state statute, the financing statement was ineffective to perfect a security interest in excess of $1,250,000.\textsuperscript{56} The creditor's failure to pay the additional tax (the tax rate was ten cents on each $100 of debt, or $700 for the $700,000 of additional debt) reduced the secured claim to $1,250,000. The trustee avoided the creditor's un-

\textit{Arnett}, however, was due to a tardy response from a prior debtor and the "holiday mails." The federal court also stressed the particular facts of the case:

When delay beyond the ten day grace period is satisfactorily explained, as in this case where it was necessary to obtain the release of American National's lien, and no risk of fraud or misrepresentation is occasioned by the delay, the statute should not prevent the courts from being able to determine that the transaction was substantially contemporaneous.

17 Bankr. at 914.

\textsuperscript{51} See, e.g., \textit{In re Butler}, 3 Bankr. 182 (Bankr. E.D. Tenn. 1980).


\textsuperscript{52} See, e.g., \textit{In re Enlow}, 20 Bankr. 480 (Bankr. S.D. Ind. 1982).


\textsuperscript{56} 23 Bankr. at 745.
perfected security interest in the additional $700,000 worth of inventory under the "strong arm" clause of section 544(a), which permits the trustee to avoid unperfected security interests, rather than under section 547.\textsuperscript{57} The trustee used section 547 to avoid over $200,000 in pre-petition payments to the secured creditor.\textsuperscript{58} The trustee avoided these pre-petition payments under the general principle that payments made within the preference period to an unsecured or undersecured creditor are preferential. This use of section 547 was directed at the payments, not at the security interest. Thus, \textit{Ken Gardner} is not an example of the use of section 547 to avoid a security interest in inventory or accounts.

To the extent that the case law to date provides reliable guidance, careful inventory and accounts lenders need not fear section 547. Unsecured creditors can expect no "trickle down" of assets. The case law, however, tells an even grimmer tale for unsecured creditors. Section 547, while bypassing the inventory and accounts lenders, is being used against unsecured creditors by the score. Unsecured creditors taking payment or obtaining liens within the preference period are the most common victims of section 547.\textsuperscript{59}

\textsuperscript{57} \textit{Id.}

\textsuperscript{58} The creditor's failure to perfect its security interest beyond the $1,250,000 figure meant that the creditor was undersecured. The trustee, using § 547, can recover prepetition payments to an undersecured creditor. \textit{See} 11 U.S.C. § 547(b) (1982).

In re Advance Glove Manufacturing Co. provides a typical example of a court's use of section 547 against unsecured creditors. On December 11, 1980, the supplier-creditor delivered goods to the debtor. Although the debtor delivered a check in payment to the creditor on or about January 20, 1981, the check was not paid by the drawee bank until February 24, 1981. The debtor filed a bankruptcy petition on March 19, 1981. The transfer of the purchase price by the check was held to be a preferential transfer. The court found the exception for ordinary course transfers made within forty-five days after the debt is incurred inapplicable because, it concluded, the "transfer" occurred when the check was paid (outside the forty-five-day period) and not when it was delivered (within the forty-five-day period). Thus, a creditor receiving an ordinary course bona fide payment was forced to give it up because it had the misfortune of bad timing.

The predominance of unsecured creditors among the section 547 victims may be due to the abolition of the "reasonable cause to believe the debtor was insolvent" element of preference. Under the old Act the trustee had to prove that the creditor, at the time of the transfer, had "reasonable cause to believe that the debtor was insolvent." Presumably, this burden discouraged trustees from pursuing many otherwise preferential transfers, particularly transfers involving relatively small sums of money. Under the new Code, which eliminates the "rea-

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63. See H.R. No. 595, 95th Cong., 1st Sess. 178, reprinted in 1978 U.S. Code Cong. & Ad. News 5953, 6139 ("Finally, the requirement that the trustee prove the state of mind of his opponent is nearly insurmountable, and defeats many preference actions. . . . It also defeats the policy of the preference section by
sonable cause” element, trustees can use section 547 against unsecured creditors more easily and appear to be doing so, even against unsecured creditors receiving relatively small transfers.64

Thus, evolving case law does not support the basic assumption that section 547 would be used against inventory and account lenders and would thereby be an instrument for asset redistribution in bankruptcy. Instead, section 547 has ironically been used against its supposed beneficiaries, the unsecured creditors.

It is tempting to move from the observation of the absence of case law examples of the avoidance of security interests in inventory or accounts receivable to the conclusion that section 547 is in fact not effecting a redistribution of assets to unsecured creditors. This leap should be resisted, however, for several reasons. First, case law may still be developing on this issue; section 547 avoidance cases involving inventory and accounts receivable lenders may be on their way. Second, the case law may never exhibit any significant level of these sorts of avoidance actions, and yet the effect may still be there. Section 547, like any statute, can have enormous effects not exhibited in the case law.65 If the parties to a potential bankruptcy proceeding know or learn about the potential effect of section 547, that knowledge may affect their negotiations. In the negoti-
ated workouts the inventory and accounts receivable lenders may be giving up part of their secured position because of the anticipated effect of section 547. If so, the effect anticipated by the drafters, though not evidenced by the case law, may still be present. It is thus essential to go beyond the case law.

III. COMMERCIAL PRACTICES AND BANKRUPTCY PRINCIPLES

A. Commercial Practices

Certain practices of creditors generally, including inventory and accounts receivable lenders, support the conclusion that section 547 will not pose a serious threat to inventory and accounts lenders. Before considering these practices it is necessary to understand the basic operation of section 547 as applied to inventory and accounts receivable security interests.

Applying section 547 to any transaction requires a two-step analysis. First, the elements of a preference as set forth in section 547(b) must be satisfied. In essence, a section 547(b) preferential transfer results if, because of a transfer to a creditor made within ninety days prior to the bankruptcy filing and on account of an antecedent debt, the creditor receives more than would otherwise have been received in a bankruptcy liquidation. Once the section 547(b) elements are satisfied, the exceptions set forth in subsection (c) must be examined. The exception applicable to security interests in inventory and accounts receivable is set forth in subsection 547(c)(5).

Application of the section 547(b) elements to security interests in inventory and accounts receivable raises several interesting questions. Inventory and accounts receivable are "quick assets," typically subject to constant sale or payment and replacement by new items of inventory or new accounts. The preference issue arises with respect to those items of inventory and accounts that come into the debtor's hands during the ninety-day preference period. When a debtor gets a new item of inventory and places that item on its shelf for sale, has there

66. For example, a creditor with a security interest in inventory or accounts receivable who feels vulnerable under § 547 might agree to a negotiated settlement yielding less than the ostensible secured claim. If the debtor's unsecured creditors in the settlement received some of that foregone claim, § 547 would produce the assumed effect, notwithstanding the absence of any case law.

67. 11 U.S.C. § 547(b) (1982). The text of § 547(b) is set out at supra note 4.


69. Kronman, supra note 5, at 143-44.
been a "transfer" to the creditor? From a commonsense, plain meaning perspective, the question could be difficult. From the Code perspective, however, it is not. The Code's definition of "transfer" is incredibly broad.70 Moreover, the drafters' intent is clear on this issue.71 When a debtor receives a new item of inventory, a security interest in that item of inventory is "transferred" to the secured creditor.

The "transfer" issue under section 547(b) is not as easily answered in less usual contexts. If, for example, the items of inventory have not changed during the preference period but have simply become more valuable because of a market shift in the value of the particular commodity, the "transfer" issue arises and cannot be so easily resolved.72 There is no new item of inventory and thus no transfer of the security interest in a new asset. Yet, a security interest in the increased value has been transferred, in effect, from debtor to secured creditor. Whether this "transfer" is sufficient for purposes of section 547(b) is unclear.73

In re Fairchild74 illustrates the problem. The creditor had a perfected security interest in, among other assets, the debtor-farmer's hogs. During the preference period the collateral increased in value in two ways. First, value increased as the hogs were fattened. Second, the hogs increased in number as a result of intraherd breeding. The court concluded no "transfer" had resulted, stating that "[i]n this situation, it is the very nature of the collateral to increase in value."75 The increase in value, attributable to the natural instincts of the collateral (presumably, the court took judicial notice of the propensity of hogs to eat and breed), did not constitute a preferential transfer.

If the Fairchild rule is extended and followed, the trustee may not be able to avoid security interests in inventory that

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70. "'[T]ransfer' means every mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with property or with an interest in property, including retention of title as a security interest." 11 U.S.C. § 101(41) (1982).

71. Section 547(c)(5) refers specifically to "a transfer . . . of a perfected security interest in inventory or a receivable." See also COMMITTEE REPORT, supra note 5, at 212, 1978 U.S. CODE CONG. & AD. NEWS at 6172.

72. For example, the market value of gold jewelry inventory in a rising gold market or citrus fruit inventory in a "killing frosts in Florida" market can rise, without any change in the particular items of inventory.

73. The Committee apparently assumed that all improvements in position, whatever the cause, would be preferential. See COMMITTEE REPORT, supra note 5, at 216, 1978 U.S. CODE CONG. & AD. NEWS at 6176.


75. Id. at 794.
has increased in value solely because of market shifts, natural instincts, or other factors not involving the addition of new items of inventory. Yet, most inventory and accounts situations will not pose the *Fairchild* issue. Typically, there will be additions to or replacements of inventory and accounts within the preference period, and the "transfer" element,76 along with the other section 547(b) elements, will be satisfied.

Once the elements of a preference in section 547(b) are satisfied, the exceptions set forth in section 547(c)(5) come into play. To illustrate the basic operation of section 547(c)(5), consider the situation of a creditor having a perfected security interest in the debtor's inventory. Assume that all items of inventory on the debtor's shelves as of the date of the filing of the bankruptcy petition were acquired by the debtor within the ninety days preceding the filing. Under section 547(b), the transfers of the security interest in all of the items of inventory constitute preferential transfers.

Section 547(c)(5) shields the creditor's security interest in the inventory, except to the extent that there has been a reduction in any deficiency. The "reduction of deficiency" notion has two basic components. First, there must have been a "deficiency" on the date ninety days preceding the filing of the petition. The term "deficiency" is shorthand for "any amount by which the debt secured by such security interest exceeded the value of all security interest for such debt."77 Second, there must have been a reduction of that deficiency. The components are conjunctive requirements. If there is no deficiency at the ninety-day mark, there can be no reduction in deficiency and the entire security interest in the inventory is excepted from preferential avoidance. If, however, there is a deficiency on the first measuring point, the reduction component becomes applicable. The deficiency as measured on the date of the filing of the petition must be less than the deficiency at the ninety-day mark. If there is both an initial deficiency and a reduction, the trustee may avoid the creditor's security interest in the collateral, but only to the extent of the reduction.78

Suppose, for example, that the value of the debtor's inventory at the ninety-day mark is $50,000 and the loan balance at that time is $100,000. Because there is a $50,000 deficiency, the

76. See supra text accompanying notes 69-71.
78. For the origin of this pro tanto idea, see COMMITTEE REPORT, supra note 5, at 216, 1978 U.S. CODE CONG. & AD. NEWS at 6176.
first element is satisfied. Assume that the loan balance remains at $100,000 and that the value of the inventory on the date of the filing of the petition is $75,000. Thus, there has been a reduction of deficiency of $25,000 ($50,000 initial deficiency less the $25,000 deficiency at filing). The trustee may therefore avoid $25,000 worth of the creditor's security interest in the inventory. Other more complex hypotheticals push the statutory language harder; however, consideration of them is unnecessary because such situations suggest, if anything, a "no preference" result. This Article thus will focus on the more common inventory and accounts problems.

Just as the value of a debtor's accounts receivable or inventory can increase, it can also decrease. The market value of a particular sort of inventory can shift downward. The price of gold, for example, can drop dramatically and a jeweler's inventory of gold jewelry can thereby decline in value. A debtor's inventory may be depleted, either by an unexpected turn of events or in the ordinary course of business. For example, during a trucker's strike the inventory of a food store in a relatively remote part of the country might be unexpectedly depleted. People concerned with the availability of food might buy out the store's inventory and thereby reduce the value of the creditor's security interest. A department store's inventory is routinely depleted during a typical December sales rush; the value of the department store's inventory at the end of December is often far less than the value of the inventory prior to Thanksgiving.

A shift in market value or depletion of the debtor's inventory does not, however, necessarily result in a deficiency. Creditors as a rule always demand and receive a cushion of collateral value in excess of the loan balance. A decrease in

79. "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." Duncan, supra note 35, at 25. Professor Duncan provides a sample of the more torturous hypotheticals. Id. at 25-29.

80. See id.

81. Creditors seek a cushion of excess collateral value for several reasons. First, they recognize that collateral value often decreases. Second, they know that accounts receivable with a face value of a particular amount are not worth that amount. Costs of collection, even when accounts are paid in the ordinary course, must be subtracted from the aggregate face value. Inevitably, some accounts will go unpaid. In the case of inventory, the costs of marketing the goods must be subtracted from their aggregate value. Moreover, creditors typically resort to collateral only when the business has failed. When a business
the value of the collateral thus might simply reduce the cushion but stop short of creating a deficiency. In the case of the expected depletion of a debtor's inventory, as in the December department store sales rush, a creditor typically takes account of the anticipated reduction in security in structuring the loan relationship. Not wishing to risk a deficiency, the creditor either starts out with a cushion large enough to cover the December depletion or requires payments during the month of December sufficient to prevent the existence of a deficiency at any point in time.82

Deficiencies, nonetheless, will occur. The failing business sliding into bankruptcy is likely to provide one of those occurrences.83 And if the timing is right, a deficiency could exist at the ninety-day mark. If this happens, the inquiry shifts to the second element, reduction of the deficiency. A reduction of deficiency will occur if there is an increase in the value of the collateral from the ninety-day mark to the date the petition is filed. Collateral sometimes does increase in value, as in the shift in market value situation. As another example, a debtor may need financing to construct and sell furniture. The lender's collateral will be the debtor's inventory. The value of the inventory will increase as the debtor transforms lumber and other raw materials to completed furniture.84 If this sort of increase in value occurs during the ninety-day period and is coupled with an initial deficiency, the trustee may be able to

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82. Payments made to fully secured creditors are generally not preferential. Such payments fail to satisfy the §547(b)(5) element of a preferential transfer because §547(b)(5) requires that the transfer actually result in a preference of the creditor, i.e., enable the creditor to receive more than would have been received in a hypothetical Chapter 7 liquidation without the transfer. Such fully secured creditors generally receive full payment in a Chapter 7 liquidation, and since full payment is all they can ever receive, the prebankruptcy payments do not cause the necessary §547(b)(5) preference effect.

83. See COMMITTEE REPORT, supra note 5, at 216, 1978 U.S. CODE CONG. & AD. NEWS at 6176 ("In the normal course of a business declining into bankruptcy the position of an inventory or receivable lender, far from improving, will almost certainly deteriorate.").

84. The drafters did contemplate the situation in which collateral increases in value through the production process. See id. at 217, 1978 U.S. CODE CONG. & AD. NEWS at 6177.
avoid the creditor's security interest, notwithstanding the exception of section 547(c)(5).

If improvements in the value of the debtor's inventory or accounts, either of the foregoing sort or some other kind, are not rare phenomena, and if these phenomena are often linked with an initial deficiency situation, section 547 might be an actual threat to accounts and inventory lenders. Yet, section 547 requires the occurrence of both events, each not all that unusual by itself but unlikely to be found in combination with the other. Typically, a creditor does not purposefully link the increase in value situation with an initial deficiency. In the lumber-to-furniture example, the creditor would normally require that the value of the raw materials at their least valuable point be sufficient to cover both the outstanding loan balance and some reasonable cushion. As the lumber is turned into furniture the increase in the value of the collateral will simply create a greater cushion or permit the debtor to draw down subsequent advances. In either case, because the cushion is retained, a deficiency will not arise.

Section 547(c)(5) requires both an initial deficiency and a reduction of deficiency. The coincidence of the reduction with an initial deficiency position should be relatively rare. The inventory and accounts receivable lender, as all other commercial lenders, abhors a deficiency and attempts to structure the relationship to avoid it under all expected circumstances. Moreover, when a deficiency arises and the debtor winds up in bankruptcy, the value of the inventory and accounts typically decreases in value.

The delicate timing of the section 547(c)(5) test also makes section 547 an unlikely tool to be used against inventory and accounts lenders. Only the financial pictures at the first measuring point and the date of the filing of the petition are relevant. A deficiency that does not arise until the eighty-ninth day before filing or later is irrelevant. Without a deficiency at the first measuring point, there is no preference and intervening fluctuations are therefore ignored.

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85. See supra note 81.
86. See 1 Giumore, Security Interests, supra note 2, § 8.3, at 259-60.
87. The drafters noted:
Intervening fluctuations in the relationship between debt and collateral . . . are ignored. . . . The [two-point test] 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. . . . There has to be a straight policy choice between the rough and ready provisions of
Furthermore, accounts and inventory lenders could respond strategically to a deficiency by quickly arranging an increase in the collateral value to cover the deficiency, followed by the debtor's filing of a bankruptcy petition. If the increase and filing can both be accomplished in less than ninety days, the creditor's security interest is invulnerable to section 547. At some point, however, the Code's fraudulent transfer provisions could apply to this sort of manipulation.

Certain facts of commercial life thus support the inference, derived from the case law, that section 547 is not a potent weapon against inventory and accounts lenders. The necessary combination of deficiency at the first measuring point and a reduction of the deficiency as of the bankruptcy filing is an unlikely combination.

B. BANKRUPTCY PRINCIPLES

Several bankruptcy principles and features also support the inference that section 547 will not threaten seriously inventory and accounts lenders. The debtor who engages in borrowing based on inventory and accounts receivable as collateral will almost certainly be a business debtor. Although most bankruptcy filings, business and individual, end up in a Chapter 7 liquidation, many business bankruptcies will be resolved within Chapter 11 reorganizations or Chapter 13 adjustments.

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88. For example, assume a creditor has a perfected security interest in the debtor's accounts. A deficiency first arises on January 1. The creditor persuades the financially failing debtor to sell off its inventory and thereby generate new accounts sufficient to cure the deficiency. The creditor thereafter persuades the debtor to file a voluntary bankruptcy petition. If all of this occurs before April 1, the creditor's security interest in the pumped-up accounts is invulnerable under § 547(c)(5) since there was no deficiency at the 90-day mark.

89. Sections 544(b) and 548 of the Code embody the fraudulent conveyance avoidance powers. 11 U.S.C. §§ 544(b), 548 (1982). Section 544(b) in effect invokes the applicable state fraudulent conveyance law. If a prebankruptcy transfer is avoidable by one of the debtor's unsecured creditors under the state law, the trustee may avoid the transfer for the benefit of the bankruptcy estate under § 544(b). Section 548 sets out the Code's fraudulent conveyance rules. In the illustration supposed in note 88 supra, the transfer of the security interest in the new accounts might be stricken under either § 544(b), depending on the particular provisions of the applicable state law, or under § 548, depending on the trustee's ability to prove that the debtor made the transfer "with actual intent to hinder, delay, or defraud" other creditors.

90. Professor Eisenberg sets out the following table showing the number
Certain features of Chapter 11 or Chapter 13 proceedings suggest that even if section 547 is potentially applicable it may not be used. First, in these proceedings the bankruptcy estate will not be liquidated and distributed to the creditors.\(^9\) Although section 547 is theoretically applicable and could be used to enhance the estate in order to facilitate the rehabilitation, there may be less pressure to invoke it in the nonliquidation setting. Second, the Chapter 11 debtor-in-possession and the Chapter 13 debtor, who largely control the bankruptcy process, may not wish to use section 547.\(^9\) The potential section 547 target may often be a creditor with whom the debtor needs to work as part of the rehabilitation process. Use or the threat of use of section 547 against the creditor may be viewed as a slap in the face to someone whom the debtor needs to keep happy.\(^9\) If the creditor is in fact a key element in the rehabilitation, the other creditors, not wishing to offend a necessary participant, may not object. Moreover, other creditors may be potentially subject to the preference provisions themselves and may all

<table>
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<tr>
<th>Year</th>
<th>Total Filings</th>
<th>Chapter 7</th>
<th>Chapter 11</th>
<th>Chapter 13</th>
<th>Other</th>
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<td>367,141</td>
<td>16,215</td>
<td>144,444</td>
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\(^9\) Typically, an individual debtor or a firm wishing to avoid liquidation will seek a Chapter 13 or Chapter 11 proceeding. Nonetheless, a Chapter 13 or Chapter 11 case may be converted to a Chapter 7 liquidation. See 11 U.S.C. §§ 1112, 1307 (1982). Even in a nonliquidation proceeding, some property of the estate may be distributed to creditors. See 11 U.S.C. §§ 1123(a)(5)(B), 1322(b)(6) (1982).

\(^9\) In a Chapter 11 proceeding the debtor firm, the "debtor in possession," may retain control of the business and avoid the appointment of a trustee to run the business. See 11 U.S.C. § 1107 (1982). Similarly, the individual debtor in a Chapter 13 proceeding may retain substantial control over his or her affairs and the bankruptcy proceeding. See 11 U.S.C. §§ 1303, 1304, 1321 (1982).

\(^9\) See generally Klee, All You Ever Wanted to Know About Cram Down Under the New Bankruptcy Code, 53 Am. Bankr. L.J. 133, 171 (1979) (noting that in most Chapter 11 cases the reorganization plan is negotiated and agreed to by the creditors).
implicitly or explicitly agree that it shall not be used against any of them. Courts may be quite willing to accept such an agreement.\textsuperscript{94} Thus, the business bankruptcies in Chapters 11 and 13 may not be fertile grounds for invoking section 547.

The Chapter 7 business bankruptcies are presumably those in which the business has no viable chance to continue.\textsuperscript{95} Typically, few nonexempt assets are present in a Chapter 7 case.\textsuperscript{96} As a result, creditors often do not engage actively in the bankruptcy. And, unless substantial assets can be recovered using section 547, the trustee will have little interest.\textsuperscript{97}

Interestingly, section 547 is commonly used in Chapter 7, but not at the behest of creditors and not by trustees. Debtors are using section 547 to avoid security interests in exempt property.\textsuperscript{98} Under section 522(h), debtors may avoid preferential transfers of exempt property.\textsuperscript{99} For example, if wages are paid over to a garnishing creditor within the preference period, and those wages in the debtor's hands would be exempt, the debtor may be able to recover the wages using sections 547 and 522(h).\textsuperscript{100} Since inventory and accounts receivable typically will not constitute exempt property, the use of section 547 in this way has virtually no impact on the inventory and accounts receivable lenders.\textsuperscript{101}

\textsuperscript{94} Presumably, so long as the creditors, who typically would be the beneficiaries of an avoidance action, do not press the matter, there would be little reason for courts to intervene sua sponte.

\textsuperscript{95} For a description of the "death knell" of a bankruptcy liquidation, see 1A P. COOGAN, W. HOGAN, D. VAGHTS, & J. MCDONNELL, SECURED TRANSACTIONS UNDER THE UNIFORM COMMERCIAL CODE § 9.01, at 972-73 (1983).

\textsuperscript{96} Id. at 974-75.

\textsuperscript{97} See infra text accompanying notes 102-105.


\textsuperscript{99} 11 U.S.C. § 522(h) (1982) provides:

The debtor may avoid a transfer of property of the debtor or recover a setoff to the extent that the debtor could have exempted such property under subsection (g)(1) of this section if the trustee had avoided such transfer if—

\begin{enumerate}
  \item such transfer is avoidable by the trustee under section 544, 545, 547, 548, 549, or 724(a) of this title or recoverable by the trustee under section 553 of this title; and
  \item the trustee does not attempt to avoid such transfer.
\end{enumerate}

\textsuperscript{100} See supra note 98.

\textsuperscript{101} State law generally exempts certain property from the reach of creditors outside the bankruptcy context. The Code brings state exemption laws into the bankruptcy context and permits bankruptcy debtors to retain the property specified in the applicable state exemption law or the property specified in
Furthermore, the trustee may choose not to invoke section 547, even where it is potentially applicable. If the cost of proving and recovering the preference are outweighed by the benefit likely to be recovered, the trustee in his or her discretion may properly forego use of section 547. Thus, the trustee, for efficiency reasons, may simply choose not to avoid small preferences.

The trustee's discretionary nonuse of section 547 for efficiency reasons may be more likely in situations involving inventory and accounts lenders than in those involving unsecured creditors. To prove a preferential transfer to an unsecured creditor, the trustee need only prove the existence of a payment within the preference period. On the other hand, to prove a preferential transfer to a creditor with a security interest in inventory or accounts, the trustee must prove the loan balances and the value of the collateral at the two relevant points in time. Determining the value of inventory or accounts is difficult. For example, should accounts be valued at their face amount, a measure that ignores risks of default and costs of collection? Should the value of inventory at the ninety-day mark be determined on the basis of the retail price marked on items at that time or by the prices at which the items are eventually sold? Whatever the definition of "value," the process of valuation can be costly. This cost may, in effect, protect the inventory and accounts creditor from the use of sec-


102. Section 547 is cast in permissive terms: "Except as provided in subsection (c) . . . the trustee may avoid any transfer of property of the debtor . . . ." 11 U.S.C. § 547(b) (1982) (emphasis supplied); see also 4 W. COLLIER, COLLIER ON BANKRUPTCY ¶ 547.01, at 547-9 n.10 (15th ed. 1983).

103. The elements of a preferential transfer will almost invariably be met once the trustee has proven a payment to an unsecured creditor within the 90-day preference period. See 11 U.S.C. § 547(b) (1982). In theory, the unsecured creditor can defeat the trustee's attack by proving that the debtor was not insolvent at the time of the payment. See 11 U.S.C. §§ 547(b)(3), 547(f) (1982). The unsecured creditor, though the recipient of a preferential transfer, may also be able to invoke one of the exceptions of § 547(c).

104. See supra text accompanying notes 77-78.

105. See Cohen, supra note 35, at 651 ("[T]he definition of 'value' can determine the existence and magnitude of a preference.").
The assumption of the drafters of section 547 was actually two-pronged. The drafters assumed, first, that section 547 would be used to avoid security interests in inventory and accounts, and second, that this use of section 547 would result in greater bankruptcy distributions to unsecured creditors. Evolving case law, commercial practice, and bankruptcy principles have undercut the first part of the assumption. If avoidance is not occurring, or the threat of it is not affecting negotiated settlement, the distribution effect cannot occur. As to the second part of the assumption, the distribution effect, one final, additional reason militates against its occurrence. Even if all the hurdles described are met and the security interest in inventory or accounts is avoided under section 547, the proceeds from that avoidance are likely to be swallowed up by priority claimants who stand between the secured creditor and the pool of general unsecured creditors, the intended beneficiaries of section 547. The exception to this may be the priority wage

106. One final limitation on the use of § 547 to avoid security interests in inventory or accounts should be noted. The trustee may avoid the security interest in inventory or accounts only if the reduction in deficiency is "to the prejudice of other creditors holding unsecured claims." 11 U.S.C. § 547(c)(5) (1982). The precise meaning of this peculiar language is unknown. Presumably, some reductions in deficiency are not to the prejudice of unsecured creditors and hence not avoidable by the trustee. The only certainty is that the words can operate, if at all, only as a limitation on the avoidance of security interests in inventory or accounts.

Professor Homer Kripke offered an interpretation of the draft statutory language that preceded the "to the prejudice" phrase:

In my opinion the creditor should keep the benefit of the improvements in the cases mentioned, so long as it is not at the expense of other parties interested in the estate. I think there is a formula for protecting the other parties against depletion of the estate for the benefit of the secured creditor in this respect. That formula is found in Meinhard, Greeff and Co. v. Edens, 189 F.2d 792 (4th Cir. 1951) which I cited to Professor Gilmore as a model for this problem on May 31, 1966. The court was there considering the problem of the allocation between the secured creditor and the estate of the value of goods which had been in process at the moment of bankruptcy and which had been finished by the trustee. The court held that the secured creditor was entitled to the entire value of the finished goods, less the costs expended by the trustee in finishing the goods. This of course was for operations which occurred after bankruptcy. There is no reason why the same principle may not be applied to expenditures by the bankrupt or debts incurred by the bankrupt within the four-month period.

COMMITTEE REPORT, supra note 5, at 210, 1978 U.S. CODE CONG. & AD. NEWS at 6170-71. The actual interpretation of the vague provision will have to evolve judicially, notwithstanding Professor Kripke's proposal. See Duncan, supra note 35, at 29-33.

107. See 11 U.S.C. § 507 (1982); see also 2 GILMORE, SECURITY INTERESTS, supra note 2, § 45.3, at 1288 ("[T]he real enemy, for a generation or more, has been the tax collector.").
claimant, who presumably is part of the set of intended beneficiaries. In the typical business bankruptcy, the priority claimants, including most tax claimants, will probably consume all of the proceeds of any section 547 avoidance. Thus, the distribution effect, even when avoidance does occur, is unlikely.

IV. SUGGESTED RESPONSE

The policies that underlie the basic assumption of section 547 are questionable. The desirability of shifting wealth from secured creditors to unsecured creditors is presumably based on fairness or efficiency grounds. It may be unfair to permit the secured creditors to take all when the contributions of the unsecured creditors often are responsible for a significant part of the wealth on hand at bankruptcy day. A distribution pat-

108. Employees enjoy a limited priority status under the Code:

The following expenses and claims have priority in the following order:

(3) Third, allowed unsecured claims for wages, salaries, or commissions, including vacation, severance and sick leave pay—
   (A) earned by an individual within 90 days before the date of the filing of the petition or the date of the cessation of the debtor's business, whichever occurs first; but only
   (B) to the extent of $2,000 for each such individual.

(4) Fourth, allowed unsecured claims for contributions to employee benefit plans—
   (A) arising from services rendered within 180 days before the date of the filing of the petition or the date of the cessation of the debtor's business, whichever occurs first; but only
   (B) for each such plan, to the extent of—
      (i) the number of employees covered by such plan multiplied by $2,000; less
      (ii) the aggregate amount paid to such employees under paragraph (3) of this subsection, plus the aggregate amount paid by the estate on behalf of such employees to any other employee benefit plan.

109. See supra text accompanying notes 11-14.

110. "Fairness" and "efficiency" are elusive concepts. "Efficiency" theory, as used in contemporary legal analysis, is a form of consequentialism. The supposed consequences of a contemplated action determine its propriety. Consequentialism dictates taking the action that is likely to generate consequences that maximize "utility-of-some-sort-or-another-whatever-it-might-be." See Soper, On the Relevance of Philosophy to Law: Reflections on Ackerman's Private Property and the Constitution, 79 COLUM. L. REV. 44, 44 n.1 (1979). Legal theorists use "fairness" as a way of suggesting that the rightness of a proposed action can be determined apart from its consequences and notions of utility-maximization.

111. As Professor Gilmore observes:

[Why on earth should the fruits of a known insolvent's labors feed the assignee while all the other creditors starve? . . . There was something worth thinking about in the limitations that the nineteenth-century courts had placed on the mortgagee's claim to after-acquired
tern that gives everything to the secured creditors and nothing to the unsecured creditors may also be inefficient. If the distribution pattern increases business failures among the unpaid unsecured creditors, the social costs of bankruptcy may increase. An alternative distribution pattern that enhances the distributions to unsecured creditors may thus produce fewer social costs.

The fairness argument against the current distribution pattern is founded on the important, often unarticulated premise that unsecured creditors either (i) do not know ab initio their likely bankruptcy distributions or (ii) are powerless to structure their credit terms to reflect the risk. Yet, many unsecured creditors are perfectly aware of the probable outcome in bankruptcy and rationally take that into account when structuring the price for their credit. To the extent that unsecured creditors charge more for credit than do secured creditors, it is perhaps not unfair for them to receive less in bankruptcy. In a sense, the unsecured creditors have received their bankruptcy distributions up front in the form of higher prices charged for credit. This explanation obviously may not work in any particular instance. Nonetheless, it is applicable

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112. See Jackson and Kronman, supra note 5, at 989.

113. The premise is stated in simplified terms. The fairness argument could raise questions about the appropriate focus (unsecured creditors as a group or individually), the knowledge point (actual or constructive knowledge), power (at what point is one “powerless”), and other issues. This Article does not, and need not, address these complications. Whatever unfairness may exist in the distribution pattern, this Article concludes that tinkering with the preference law is not a sensible or effective response. See infra text accompanying notes 117-21.

114. Consider, for example, the differing interest rates charged the same debtor for secured and unsecured loans. The interest rate on home mortgage loans is normally less than the interest rate on credit card loans. Although other factors are involved, the creditor's recognition of the effect of security (or its absence) in bankruptcy is surely part of the explanation of the differing rates.

115. For example, a particular unsecured creditor might extend a large amount of unsecured credit at a high interest rate to one particular debtor. If the debtor falls into bankruptcy before the creditor has had an opportunity to spread its credit over a larger group of debtors, most of whom will most likely
to the unsecured creditors as a class and over time. And this is presumably all that could be realistically expected of any federal bankruptcy scheme. If in the usual case unsecured creditors are treated fairly, the complaint of the exceptional unsecured creditor probably will have to be tolerated in any system.

The fairness argument persists, however, in one particular situation, that of the employee-creditor. An employee extends credit to his or her employer because of the phenomenon of paying wages in arrears. The paycheck received today usually represents the work done over the previous week or month. In this way employees can become unsecured creditors of a bankrupt debtor-employer. If these employees were either unaware of their status in bankruptcy or unable to demand that this feature of their status be taken into account in setting the price for their labor, the distribution pattern in bankruptcy as applied to the employees might be unfair.  

Although some employees may not fit the "no bargaining power" model, the drafters of the new Code seem to have accepted to some extent this fairness argument. Employees' wage claims enjoy a limited priority in bankruptcy. This priority status does the employees little good, however, if, as is often the case, all of the assets are swallowed up by the secured claimants. Thus, the bankruptcy distribution scheme perhaps should provide more for the employee-creditors, as a matter of fairness. The current priority status, moreover, may be an insufficient response to this problem.

The essential question then becomes how to respond to this perceived unfairness. One possibility is to amend section 547 to put more inventory and accounts receivable security interests at risk and thus increase the application of section 547 to those creditors. This response, however, would be crude and ultimately ineffective. First, the needy employee-creditors will not always be linked with a substantial amount of inventory avoid failure, the creditor may itself fail, notwithstanding the higher interest rates charged for the unsecured credit.

116. The independent, individual employee typically will know nothing of bankruptcy distribution patterns until it is too late for him or her to do anything about it. Even if the employee acquires first-hand knowledge, however, in virtually all cases the employee will lack the power to demand security for the wages. The presence of labor unions complicates the picture. National labor unions with legal staff presumably have knowledge of the legal status of wage claims in bankruptcy. How, or whether, they use the knowledge is unclear.

117. See supra note 108.
and accounts acquired by the debtor within any reasonable preference period. For example, if the debtor's assets consist primarily of equipment, a form of collateral that usually is not subject to rapid turnover, putting teeth into section 547(c)(5) would do no good. Employee-creditors might still receive no bankruptcy distributions, even under a revised section 547. Moreover, using section 547 to avoid security interests in inventory and accounts may benefit substantially nonemployee unsecured creditors, creditors who presumably have the knowledge and power to take care of themselves. To use section 547 to transfer assets from the inventory and accounts lenders to these sorts of unsecured creditors would likely amount to merely substituting one form of unfairness for another. Explicitly limiting section 547 avoidance of security interests in inventory and accounts to the needs of employee-creditors would solve these objections. It would also create a commercially undesirable state of uncertainty, however. Inventory and accounts creditors would have to rely on the absence of unpaid wage claims, a condition over which the creditor typically has no control and one over which the creditor could gain control only at enormous cost and inconvenience.

Amending section 547 to put inventory and accounts security interests at greater risk, as a means of shifting wealth from secured to unsecured creditors, may be necessarily ineffectual. Commentators have questioned the notion that legal rules can redistribute wealth in contractual settings. In the section 547 context, secured creditors could respond strategically to any new rule by insisting on terms and conditions that negate the risks imposed by a redrafted section 547. For example, a re-

118. For example, a redrafted § 547 could provide for avoidance of security interests in inventory and accounts to the extent necessary to provide funds to pay any wage claims in the particular bankruptcy proceedings.

119. Theoretically, a secured creditor could monitor the debtor's payroll process, assuring to some degree payment of the wages. Effective monitoring of the payroll, however, could be quite costly when, for example, there are many employees spread over multiple job sites.

120. See, e.g., A. Polinsky, An Introduction to Law and Economics 107-10 (1983); Demsetz, When Does the Rule of Liability Matter?, 1 J. Legal Stud. 13, 16-18 (1972) (in contractual settings with low transaction costs, the rule's redistributive effect is likely to be blunted); Epstein, The Social Consequences of Common Law Rules, 95 Harv. L. Rev. 1717, 1720 (1982) (parties' subsequent conduct can undo a rule's ostensible wealth transfer effect).

121. Professor Polinsky describes the phenomenon in the context of the choice of legal rules for remedies for breach of contract:

In general, the parties will take any distributional effects of breach of contract remedies into account when setting the contract price; thus, how the joint benefits of entering into the contract are shared between
drafted section 547 that increased the preference period would put a larger chunk of inventory and accounts at risk. Yet, if the “deficiency” element were retained, secured creditors could respond by terms and conditions that made deficiencies less likely to occur. Even if the statute were drafted to impose absolute forfeitures on secured creditors (for example, by making avoidable security interests in all inventory or accounts acquired within ninety days of bankruptcy), a redistribution of wealth may not occur. Secured creditors might respond to this real and unavoidable increase in risk by increasing the cost of their credit. If unsecured creditors in fact would benefit from a redrafted statute, debtors would demand lower interest rates from unsecured creditors. The parties would take into account the change in risks and, by their contracts, offset any redistributive effects of a new statute.

A direct subsidy would be a better response to the unfair treatment of employees and other unsecured creditors. If employees receive too little in bankruptcy distributions, the simplest response is to pay these employees directly. The revenue pool from which these payments would be made could be created out of the debtor’s assets in bankruptcy so that all creditors would share in the creation of the pool of funds, although this would have obvious implications for the pricing structure of credit in our society. Alternatively, the revenue pool could be created out of tax revenues, either general tax revenues or a tax on employees’ wages generally. Such a system already exists to a degree in several government entitlement programs. Whatever system is adopted to create the revenue pool, the spreading of this cost could be dispersed among a wider group of people than the group of employees unfortunate enough to end up working for a business that goes bankrupt.

A difficulty with the direct subsidy approach is that it would carry with it an unknown set of effects. For example, if wage claims are underwritten, employees may stay on the job,

the parties depends primarily, if not exclusively, on their relative bargaining strengths, not on the remedies available to them.

A. Polinsky, supra note 120, at 108-09.

122. A direct subsidy system, however, will generate administrative costs. Redistribution of wealth by subsidy may also create inefficiencies. See infra text accompanying note 124; see also A. Polinsky, supra note 120, at 105-07.

123. Obviously, the contemporary American welfare system is imperfect. If social programs ever reach the point of assuring all citizens a decent standard of living, the fairness argument for altering bankruptcy distributions will be blunted.
despite the hopeless insolvency of the firm, and thereby only prolong the existence of the firm. The longer the firm stays in existence, the greater may be the amount of other unsecured and unpaid debt.\textsuperscript{124} Thus, direct subsidy may solve one problem only at the cost of creating others.

Although fairness notions might suggest a need for a change in the current bankruptcy distribution pattern, section 547 and the inventory and accounts creditors are the wrong tools to use. Direct subsidy, although seemingly a more effective and fairer tool, must be evaluated with a consideration of its collateral effects.

The efficiency argument for redrafting section 547 can be addressed in much the same way. If the present bankruptcy distribution scheme in fact increases the social costs of bankruptcy to an inefficient level, the problem is in choosing the appropriate tool for response. The preference tool is too crude. It depends upon the coincidence of the essential factual elements and the trustee’s exercise of discretion in choosing to use the tool. Moreover, creditors are likely to respond to an amended preference provision by strategies designed to avoid the impact of the amended provision. Such strategic behavior will itself generate additional costs.\textsuperscript{125} Finally, the preference tool may be ultimately ineffectual to shift these costs from unsecured creditors to secured creditors. If section 547 is redrafted to impose real risks on secured creditors and correspondingly real benefits on unsecured creditors, the parties may simply adjust the price of credit so that the unsecured creditors still bear the existing costs, in the form of lower interest rates traded off for higher bankruptcy distributions. This, of course, might have an insurance effect: unsecured creditors would be paying premiums in the form of lower interest rates to protect themselves against catastrophic losses in a bankruptcy.\textsuperscript{126} Yet, most unsecured creditors extend credit to multiple debtors and thereby already have an insurance policy of sorts. So long as only a few

\textsuperscript{124} See supra notes 5 & 12.

\textsuperscript{125} If the strategic behavior is generally successful in avoiding the impact of the amended preference provisions, a redrafted provision would produce only the additional costs of the strategic behavior and not the redistribution effect.

\textsuperscript{126} This insurance effect is of course possible under any bankruptcy distribution pattern. In essence, the unsecured creditor is always a self-insurer trying to build up a reserve against future losses in a debtor’s bankruptcy. Changes in the bankruptcy distribution pattern merely alter the risks and thereby alter the reserve requirements.
of their debtors go bankrupt, unsecured creditors should be able to sustain the losses.

Finally, any amendment of section 547 would be costly. First, there are the obvious and common costs of any statutory revision, for example, the time and effort of drafting committees, congressional committees, and the members of Congress.127 Second, an amended section 547 would certainly give rise to its own new and peculiar problems. A virtue of the existing provision is that it is moving into its adolescence. The affected parties, debtors and creditors alike, presumably have some sense of the nature of this statute and have made necessary adjustments. Any revision would trigger costly readjustments by the players. Thus, although the present distribution scheme may be either unfair or inefficient, the preference provision is an inappropriate tool to use to combat these ill effects.

V. CONCLUSION

The drafters and early critics of section 547 based their analyses on a mistaken assumption. Security interests in inventory and accounts receivable are not at serious risk. The desired redistribution of wealth to the unsecured creditors will not occur. Despite this mistaken assumption, however, section 547 should not be redrafted. Although the efficiency and fairness issues remain unresolved, redrafting section 547 would be a problematical response.

When people set out to create a law for the future, they must make assumptions about future effects. Because we cannot predict the future, the assumptions sometimes will turn out to be wrong. Yet, we should not abandon the effort rationally to construct new law; we should simply be aware of our limitations.