University of Michigan Journal of Law Reform

Volume 2

1968

Preferential Transfers on the Eve of the Bankruptcy Amendments

Richard M. Kohn
University of Michigan Law School

Follow this and additional works at: https://repository.law.umich.edu/mjlr

Part of the Commercial Law Commons, Legislation Commons, and the Secured Transactions Commons

Recommended Citation
Richard M. Kohn, *Preferential Transfers on the Eve of the Bankruptcy Amendments*, 2 U. MICH. J. L. REFORM 259 (1968).
Available at: https://repository.law.umich.edu/mjlr/vol2/iss1/12

This Note is brought to you for free and open access by the University of Michigan Journal of Law Reform at University of Michigan Law School Scholarship Repository. It has been accepted for inclusion in University of Michigan Journal of Law Reform by an authorized editor of University of Michigan Law School Scholarship Repository. For more information, please contact mlaw.repository@umich.edu.

PREFERENTIAL TRANSFERS ON THE EVE OF THE BANKRUPTCY AMENDMENTS

*Richard M. Kohn**

I. Introduction

According to Professor Grant Gilmore,[1] Section 9-108 of the Uniform Commercial Code[2] has been characterized by some observers as "an almost laughably naive attempt to perpetrate a fraud on the Bankruptcy Act." The "fraud" was aimed at Section 60 of the Bankruptcy Act,[3] which gives the trustee in bankruptcy the power to avoid, as "preferential", transfers of property "for or on account of an antecedent debt" made by a debtor while insolvent and within four months prior to his bankruptcy. Partially as a result of an internal inconsistency in the language of Article 9, Section 60 casts a distressing shadow over certain security interests in after-acquired property. According to Section 9-204(3) of the Code, "a security agreement may provide that collateral, whenever acquired, shall secure all obligations covered by the security agreement." If, on May 1, *A* lends *B* $100,000 secured by all of *B*'s accounts receivable and inventory "now in existence or hereafter acquired", it is arguable that *A*'s security interest in *all* of the collateral arose on May 1. Yet Section 9-204(1) stipulates, inter alia, that a security interest cannot be created until the debtor has "rights in the collateral." Thus under that section, *A* receives his security interest in a piecemeal fashion, as new receivables and inventory are acquired. Since there is a time gap between the original advance of $100,000 and the subsequent "transfers", the transfers are technically for antecedent

---

*Mr. Kohn is a member of the Editorial Board of *Prospectus*.

[1] 2 G. Gilmore, Security Interests in Personal Property 1309 (1965).

[2] Section 9-108 provides:

> When After-Acquired Collateral Not Security for Antecedent Debt. Where a secured party makes an advance, incurs an obligation, releases a perfected security interest, or otherwise gives new value which is to be secured in whole or in part by after-acquired property his security interest in the after-acquired collateral shall be deemed to be taken for new value and not as security for an antecedent debt if the debtor acquires his rights in such collateral either in the ordinary course of his business or under a contract of purchase made pursuant to the security agreement within a reasonable time after new value is given.

[3] 11 U.S.C. 96 (1963).

debt. If any of these transfers take place within four months prior to *B*'s bankruptcy, at a time when A has reasonable cause to know of *B*'s insolvency,[4] a preference has arguably taken place.

Section 9-108 was fashioned by the draftsmen of the Code to insulate such transfers from attack under Section 60. It provides that certain security interests in after-acquired property are deemed to be taken for new value and not as security for an antecedent debt.

Recent cases have made it clear that the "fraud" perpetrated by Section 9-108 has to some extent succeeded: to date, three U.S. District Courts have upheld the validity, in bankruptcy proceedings, of security interests in after-acquired property.[5] Yet despite these decisions, Section 9-108 of the Code and Section 60 of the Bankruptcy Act are left in an uncomfortable limbo. Proponents of the Bankruptcy Act will never be convinced that the words of a federal statute can somehow be modified by a chorus of forty-nine state legislatures. Neither will they submit easily to the view that the "conflict" between the two sections is a conflict of words alone, and that the two provisions represent essentially consistent judgments of policy. Equally important, Bankruptcy Act proponents are probably fearful that the judicial resolution which has emerged from *Rosenberg, Portland* and *White*[6] will serve as a base-point from which even greater attacks upon the preference provisions can be launched by the courts.

Hence, while secured lenders may be content to ride the crest of current judicial legislation, the only permanent solution to the problem lies in amending either the Bankruptcy Act, the Uniform Commercial Code, or both. This at least is the view taken by the National Bankruptcy Conference's Committee on Coordination of the Uniform Commercial Code and Bankruptcy Act.[7] Since its first meeting in June 1966, the Committee has focused its attention primarily upon the validity, in bankruptcy proceedings, of Article 9 security interests in after-acquired property. In September 1967, the Committee submitted to the Bankruptcy Conference its first draft of a revision of Section 60(a) of the Bankruptcy Act. This Draft was ap-

---

[4] This requirement is supplied by Section 60(b), and is discussed at p. 268 *infra*.

[5] Rosenburg v. Rudnick, 262 F. Supp. 635 (D.C. Mass. 1967); *In re* Portland Newspaper Publishing Co., 271 F. Supp. 395 (D.C. Ore. 1967); *In re* White, Bankruptcy No. 46,711 (D.C. Ohio 1967), 4 UCC Rep. 972.

[6] *Id.*

[7] At the present time the Committee members are: Prof. Grant Gilmore (Chairman), University of Chicago Law School; Herbert H. Anderson, Esq., Portland, Oregon; Peter F. Coogan, Esq., Boston, Massachusetts; Prof. Vern Countryman, Harvard Law School; Leon S. Foreman, Esq., Philadelphia, Pennsylvania; Prof. Frank Kennedy, University of Michigan Law School; Prof. Stefen A. Riesenfeld, University of California Law School (Boalt Hall); George M. Treister, Esq., Los Angeles, California; Referee Elmore Whitehurst, U.S. District Court, N.D. of Texas. The following individuals are presently serving in an advisory capacity with the Committee: Prof. Robert Braucher, Harvard Law School; Prof. Homer Kripke, New York University Law School; and Prof. Harold Marsh, UCLA Law School.

proved in terms of its "general approach."[8] Since that time the Draft has undergone significant modifications, and will doubtless undergo many more before it is finally submitted to Congress. Yet it is not premature to examine the general direction in which the Committee is moving.

It would be both unrealistic and impossible to "freeze" the current Committee discussion in order to examine its progress at a given point in time. At this point it would be more pertinent to focus upon the basic changes which have been proposed or considered for Section 60 by the Committee, some of which have already been incorporated into the Draft. This article will deal primarily with the Committee's treatment of security interests in after-acquired property, but will also touch upon various proposed modification of Section 60 which do not directly affect the after-acquired property problem.

II. Security Interests in After-Acquired Property

The Draft Amendments stipulate, with certain significant exceptions discussed below, that transfers of inventory and receivables pursuant to the terms of a properly perfected security agreement and within four months prior to bankruptcy shall not constitute preferences, provided that the receivables arose and the inventory was acquired by the debtor in the ordinary course of his business.

This rule is qualified by a "two-point" test: there *shall* be a preference to the extent that the aggregate value of the inventory or receivables, or both, subject to the security agreement on the date the petition in bankruptcy is filed, exceeds the aggregate value subject to the security agreement precisely four months earlier. Under the two-point test a preference is measured solely by reference to these two points in time, irrespective of fluctuations in the collateral which may occur within the four month period.

In order to discuss the various possible preferential situations which can arise under the two-point test, it will be helpful to isolate two distinct sorts of financing arrangements. The arrangement which has served as a hypothetical straw-man for most of the legal dialogue in this area consists of a single advance of funds secured by inventory and/or receivables "now in existence or hereafter acquired." The second financing arrangement consists of a series of advances secured by periodic transfers of inventory and/or receivables. This so-called "revolving" loan arrangement is the most common form of receivable and inventory financing. The periodic advances made against a constantly changing mass of collateral may serve as present consideration for the transfers; in such a case, a clear-cut threat of transfer

[8] SUMMARY OF PROCEEDINGS OF NATIONAL BANKRUPTCY CONFEREFNCE, 1967 ANNUAL MEETING AT WASHINGTON, D.C., Sept. 15-16, 1967. Resolution No. 1 provides: "Resolved, that the Conference approves the general approach taken by the Committee on Coordination of the Uniform Commercial Code and Bankruptcy Act with respect to revision of Bankruptcy Act Section 60(a)."

for antecedent debt is obviated.[9] Yet the shadow of preference lurks about these revolving arrangements in more subtle and complex ways.[10]

A. The Single Advance

If *A* loans *B* $100,000 secured by all inventory and receivables "now in existence or hereafter acquired", and the aggregate value of inventory and receivables remains constant throughout the four-month period, there will be no preference under the two-point test.

To this extent the Draft Amendments incorporate the holding of the well-known *Portland* case.[11] In that case, a total advance[12] of $55,300 was made against existing and after-acquired accounts. The aggregate face value of billed receivables subject to the security agreement when the trustee undertook collection was $141,463.48, while the aggregate value at the beginning of the four-month period was $144,255.70. While a two-point test was not explicitly articulated in the court's opinion, the court was obviously impressed by the fact that the creditor did not "improve his position" during the four-month period.[13]

It must be emphasized that the Draft's two-point test looks only to the aggregate value of collateral at the beginning and end of the four-month period and is not affected by fluctuations in value during that period. Thus, if the aggregate value of collateral subject to the security agreement is $100,000 four months prior to the petition, rises to $150,000 two months later, and finally settles back to $100,000 on the date the petition is filed, a preference will not result under the two-point test. Similarly, there will be no preference if, instead of rising during the four-month period, the collateral sinks to $75,000.

All *increases* in value measured by the two-point test are stigmatized as preferential under the Draft Amendments.[14] While prior versions of the Amendments explicitly insulated certain increases in value from attack,[15]

---

[9] *See* 2 G. Gilmore, Security Interests in Personal Property 1309 (1965), "Inventory and receivables financing arrangements have rarely run the §60 gauntlet . . . for the very good reason that such arrangements . . . have been carried out on a new value or revolving credit basis. The lender has given a 'new and contemporaneous consideration' against each account as it arises, and against each item of inventory as it comes in ."

[10] *See* p. 265 *infra.*

[11] *In re* Portland Newspaper Publishing Co., 271 F. Supp. 395 (D.C. Ore. 1967), presently pending on appeal in the United States Court of Appeals for the Ninth Circuit (No. 1148 filed Apr. 2, 1968).

[12] Although two advances were actually made by the lender, the advances were sufficiently close in time to be regarded as a single advance for our purposes.

[13] 271 F. Supp. at 401.

[14] Of course, to the extent that the debtor is fully collateralized throughout the four-month period, an increase in the aggregate value of the collateral will not be stigmatized as preferential under the two-point test.

[15] *E.g.*, increases resulting from fluctuating market values of collateral, from acces-

these exemptions were not included in subsequent drafts, primarily to facilitate administration of the two-point test. It is at least arguable, however, that the price to be paid for ease of administration is a series of potential inequities:

Accession and the Conversion of Inventory into Receivables. Under the two-point test an increase in the aggregate value of collateral measured at the beginning and end of the four-month period is preferential to the extent it results from accession[16] and the conversion of inventory into receivables.

While the ostensible purpose of the two-point test is to prevent a creditor from improving his position vis-a-vis the debtor's estate, it is arguable that increases in value resulting from accession and conversion of inventory into receivables do not reflect an improvement of the creditor's position. A sophisticated commercial lender evaluates a prospective borrower as a "going concern" and not as a mere aggregation of lifeless assets and liabilities. In other words, in initially determining the feasibility of making the loan, the lender takes into account the potential increases in the value of the inventory which will result from accessions and/or conversion into receivables; for it is ultimately these increases which will enable the borrower to repay the loan. To the extent that a lender relies upon such an assessment, his "position" relative to the debtor's collateral is defined at the outset of the loan. Thus, any increase in the aggregate value of collateral resulting from accession and the conversion of inventory into receivables is not so much an "improvement" of the creditor's position as it is a reflection of what the creditor bargained for at the time he entered into the loan.

A useful analogy might be made to the "entity theory" of after-acquired property.[17] According to this theory, a debtor's inventory and receivables are to be viewed as a single mass — a distinct entity — as opposed to a multitude of isolated units. A security interest in this mass can be transferred at the time the loan is made, and hence the transfer of after-acquired property conceptually escapes characterization as a transfer for antecedent debt. In like manner, increases in value which result from accession and the conversion of inventory into receivables can be viewed not merely as an aggregation of isolated increments in value, but rather as a total increase in the value of collateral, an increase which was contemplated at the outset of the loan.

---

sions, and from the conversion of inventory into receivables and other proceeds. The later two are discussed *infra.*

[16] Accession refers to the transformation of raw materials into finished goods. This includes increases in value resulting from the application, to raw materials and work in process, of labor, plant and equipment, research and development, and all of the other factors which make a finished widget more valuable than its component parts.

[17] The entity theory was first articulated by Judge Magruder in Manchester Nat'l. Bank v. Roche, 186 F.2d 827, 831 (1st Cir. 1951) (dictum) in construing the New Hampshire Factor's Lien Act.

It may well be argued that increases in value due to accessions or conversion into receivables will not often be stigmatized as preferential under the Draft. If the existing collateral at the beginning of the four-month period includes either work in process, finished goods or receivables, the accession and conversion values already inherent in this collateral would provide a higher base-point from which any preference would be measured under the two-point test. The presence of work in process, finished goods or receivables, however, cannot be counted upon in relatively new businesses or in businesses seriously strapped for funds.

In fairness to the Draftsmen of the proposed Amendments, it must be conceded that the detailed inquiry necessary to determine the precise extent to which an increase in value during the four-month period resulted from accessions or conversion into receivables would place an onerous burden upon the courts. Perhaps this is the ultimate justification for the Committee's treatment of accessions and conversions. The resulting inequities may well be the price for practicability of administration.

Seasonal Build-ups of Collateral. A second situation in which the two-point test may have undesirable results occurs in the context of seasonal build-ups of inventory and receivables. A manufacturer of artificial Christmas trees, for example, may conduct a significant build-up of inventory from March through the Christmas season, generating the bulk of his receivables in November and December.

It is possible to envision a situation in which a petition is filed against a debtor in the middle of his peak season, at a point in time when the aggregate value of his inventory and receivables is greatly in excess of what it was four months prior to the filing. Yet under the two-point test there would be a preference to the extent of the increase in aggregate value.

One can question whether this increase should be stigmatized as preferential. The debtor's inventory and receivables may well have been inadequate to collateralize the loan properly when it was made; as a result, the lender may have entered into the transaction on the basis of the contemplated seasonal build-up.[18]

The likelihood of such an occurrence is of course lessened by a number of factors. In the first place, it is unlikely that a seasonal build-up of inventory will occur on the eve of bankruptcy. When the storm clouds gather, a debtor will normally draw down existing stockpiles of inventory or at least taper off acquisitions of new inventory. In the second place, commercial lenders normally handle inventory build-ups in terms of periodic advances, or else tie a single advance against inventory to a series of advances against receivables and cross-collateralize the entire package. The periodic advances may serve as present consideration for the inventory as it becomes subject to the security agreement, and hence the threat of preference can be laregly eliminated. Still, there are and always will be

[18] *See* Hogan, *Games Lawyers Play with the Bankruptcy Preference Challenge to Accounts and Inventory Financing,* 53 CORNELL L. Q. 553, 564-565 (1968).

debtors who manage to conduct inventory build-ups on the eve of bankruptcy, and lenders who make single advances against inventory alone, and the infrequency of such occurrences across the board does not mitigate the harshness, for the individual lender, of this particular application of the two-point test.

Problems in Valuation. The Draft fails to define "aggregate value" — an omission which could have serious results in the context of receivables financing. There is often a disparity between the "face value" and the "actual value" of a debtor's receivables during the months preceeding his bankruptcy. The quality of new receivables might decline as the debtor compromises his credit standards in order to sell remaining inventory. In addition, there exists an unfortunate tendency of account debtors to develop "excuses" for nonpayment upon learning of a creditor's impending bankruptcy.[19] Yet the Draft does not indicate which form of value is to be used in measuring a preference under the two-point test — presumably leaving the question open for judicial interpretation.

It is unclear that either method of valuation is entirely satisfactory. The use of face value could have harsh results for the secured lender. Receivables with a face value of $100,000 may be worth more as collateral than receivables with a face value of $200,000, if the latter are generated on the eve of bankruptcy and therefore more likely to be uncollectible. But if these were the aggregate value of receivables subject to the security agreement at the beginning and end of the four-month period respectively, there would be a preference of $100,000 under the two-point test. An actual value test, on the other hand, would create administrative problems. Since the actual value of receivables can ultimately be measured only when their collectibility is established, a wait of thirty, sixty or ninety days might be necessary. Such a wait might be administratively unfeasible when measuring the value of receivables subject to the security agreement on the date of the petition. In view of the difficulties attendant upon the application of either method of valuation, perhaps the draftsmen were wise to leave the choice to the courts, which are in a position to balance the equities in each individual case.

B. Revolving Loans

By focusing primarily upon the single advance situation, the law review commentary[20] and the cases[21] have not touched upon the realities of in-

[19] This tendency is especially great where the debtor gives a product warranty to his account-debtor. *See* EMPLOYEES MANUAL ON METHODS AND OPERATIONS, a bulletin put out by the National Commercial Finance Conference, at 17.

[20] *See* Gordon, *The Security Interest in Inventory Under Article 9 of the Uniform Commercial Code and the Preference Problem,* 62 COLUM. L. REV. 49 (1962); King, *Section 9-108 of the U.C.C., Does It Insulate the Security Interest from Attack by a Trustee in Bankruptcy?,* 114 U. PA. L. REV. 1117 (1966).

[21] *See* Note 5 *supra.*

ventory and receivable financing. As a recent issue of *The Practical Lawyer* pointed out:

> A discussion of bankruptcy preferences in the context of individual transfers within the four-month period does not carry us far toward solution of the practical problems of loans in which collateral is assigned every day. Even the *Portland* case . . . has little relevance. While it involved shifting collateral, it did not involve shifting debt. The real problem is far more complicated . . . the trouble with the reported cases is that they are just not real. They don't deal with the practical case.[22]

While the Draft Amendments do not address themselves specifically to the "practical cases", it is arguable that they resolve them implicitly. Take the following example:

On January 2, a commercial lender, *C*, agrees to make periodic advances of *up to* 80% of the face value of *D*'s accounts receivable.[23] Pursuant to the loan agreement, *D* remits to *C*, in kind, all collections received from *D*'s account debtors. *C* then deducts from these collections the total of his advance plus the applicable service charge and remits the balance, or "equity", to *D*. By May 1, it has become apparent that receivables transferred in February and March are uncollectible. Since collections from these receivables are not forthcoming, *C*, pursuant to the terms of his agreement, exercises his option to retain any equity on subsequent collections from better receivables and apply them to the outstanding indebtedness created by the prior advances against uncollectible receivables. On August 1, unsecured creditors of *D* file an involuntary petition in bankruptcy.

---

[22] 13 PRAC. LAW. 56, at 57 (1967).

[23] The percentage used in any given arrangement depends upon a multitude of considerations, such as the debtor's financial condition and the nature of the collateral. These are not factors which can be thrown into a computer to arrive at an optimum percentage. Rather, they gain meaning in the hands of an experienced lender. Eighty percent is not an uncommon figure in receivable financing, although it may go as low as thirty, and occasionally as high as one hundred. One yardstick is the prime cost to the borrower of the product covered by the receivable, which often turns out to be around 80%. The debtor's normal rates of discounts, returns and allowances may also affect the percentage. The higher these rates are, the lower the percentage advanced. (EMPLOYEES' MANUAL ON METHODS AND OPERATIONS, pp. 8 and 13. *See* Note 19 *supra.*)

It is possible to argue that a preference has taken place, since the application of the "equity" proceeds to an indebtedness arising from prior advances can be analogized to a transfer for antecedent debt. The preference might be increased if *C*, upon realizing that continued advances of 80% would be unrealistic in view of the poor quality of *D*'s receivables, reduces his loan-to-collateral ratio from 80% to 60% and applies the entire 40% equity against outstanding debt.[24]

Since the Draft's two-point test looks only to the value of collateral at the beginning and end of the four-month period, it would appear that the conduct of the hypothetical lender would not create a preference in either situation. In the first case, where *C* has applied the 20% equity to past indebtedness, it is arguable that such equity constitutes an addition to collateral. However, there would still be no preference under the two-point test so long as the aggregate value of collateral on the date of the petition is equal to or less than the aggregate value four months earlier. In the second case, where *C* has reduced the loan-to-collateral ratio, there would also be no preference under the Draft Amendments, since the adjustment serves only to reduce the indebtedness which *D* can subsequently incur and does not affect the value of collateral subject to the security agreement.

This result finds support in the Uniform Commercial Code. As we have seen,[25] Section 9-204(3) sanctions security interests in after-required property. Within the context of revolving loans, this means that all receivables and inventory against which an advance is made serve as collateral not only for that advance, but for all prior advances made under the terms of the security agreement. In order to find a preference in the revolving loan situation, it is necessary to view the entire financing arrangement conceptually as a *series* of smaller financing arrangements, each consisting of a single advance secured by a specific assignment of collateral. Only in this way can the advances made prior to the four-month period be considered "antecedent." Yet section 9-204(3) suggests an entirely different conceptual approach to revolving loans. Such arrangements are not viewed as a series of small financing arrangements, but as one entire arrangement — a series of advances secured by a flow of collateral. Advances and collateral interact as a single organism. In this posture the very concept of "antecedent debt" loses meaning.

Further support for the above interpretation of the Draft's treatment of revolving loans is lent by the *Portland* case. While *Portland* did not deal specifically with a revolving loan situation, it impliedly went much further

---

[24] A recent pre-Code case, Shaw v. Walter E. Heller & Company, 385 F2d 353 (5th Cir. 1967), *cert. denied,* ________ U.S. ________ 36 L.W. 3382 (April 4, 1968), resolved this issue in favor of the trustee in bankruptcy. This opinion will doubtless be the subject of much criticism. One knowledgeable bankruptcy attorney has already nominated it as the "overall worst opinion of the year."

[25] *See* p. 259, *supra.*

on its facts. In *Portland,* no advances whatsoever were made during the four months preceeding bankruptcy. If there is no preference in that situation, there is *a fortiori* no preference where at least some new value is given in the form of periodic advances, whether the advances are made at 80% of the face value of receivables, or only 60%.[26]

III. Other Aspects of the Draft Amendments

A. Definition of Preference: the "Reasonable Cause to Believe" Requirement

Under present law, a preference is defined in terms of eight elements. Seven of these are set forth in Section 60(a)(1): there must be (1) a transfer, (2) of any property of the debtor, (3) to or for the benefit of a creditor, (4) for or on account of an antecedent debt, (5) made or suffered by the debtor while insolvent, (6) within four months before the filing of the petition in bankruptcy, (7) the effect of which transfer will be to enable such creditor to obtain a greater percentage of his debt than some other creditor of the same class. An eighth element is supplied by Section 60(b): at the time of the transfer the transferee must have at least reasonable cause to believe the debtor to be insolvent.

The latest Draft has carried forward the first seven elements without change. It appears, however, that the "reasonable cause to believe" element may be eliminated by the Draft Committee.[27] This is not an uncontroversial proposal. The requirement that the creditor have at least reasonable cause to believe the debtor to be insolvent has provided an often crucial factual defense, and the elimination of this defense will not find ready acceptance among secured lenders.[28] On the other hand, such a step would significantly lighten the burden of proof on the trustee, and hence the burden of time and energy on the bankruptcy court.

---

[26] This analogy was used recently by the U.S. District Court in Florida in *In re* Gibson Supply Co. Inc., No. 1619-P (D.C. Fla. Dec. 20, 1967), *Mem.*, in a case involving a standard revolving receivable financing arrangement. Even prior to the four-month period, the finance company began to reduce its advances to Gibson. Finally, advances were cut off completely at a point, coincidentally, just prior to the beginning of the four-month period. During the next four months, collections from receivables were applied by the lender to reduce the outstanding debt. A charge of preference was levelled by the trustee as to the entire collections during the four-month period. According to counsel for the finance company, the referee had indicated that he would accept the trustee's argument. While he was deliberating, the U.S. District Court in Oregon handed down its opinion in *Portland* reversing the earlier decision by Referee Snedecor. A short time later, allegedly on the basis of *Portland,* the Florida referee denied the trustee's claim for preference.

[27] One of the two resolutions passed by the Bankruptcy Conference in September 1967 gave the Committee authority to "consider the revision of the other subdivisions of Section 60 (other than Section 60(a)(1))."

[28] The response from the few commercial lenders to whom this possibility was posed fully bears out this prediction.

It is not a simple matter to forecast the effect which such an amendment will ultimately have. At first blush it would appear that the sole effect will be to favor the trustee, and hence unsecured creditors, at the expense of secured lenders. Yet such an appraisal may be misleading. Secured lenders such as banks and finance companies are often reluctant to abandon a troubled debtor, even as the storm clouds of bankruptcy gather, in the hope that together they can turn the tide of the debtor's financial woes. The natural response of secured lenders to the elimination of such a traditional legal stronghold as the "reasonable cause" requirement would be to lessen this reluctance. More debtors would be left floundering, the lines to the bankruptcy courts would become longer, and the newfound economies in judicial time and energy would be minimized if not utterly lost.[29]

The deletion of the "reasonable cause" element is just one aspect of an amendment which, in many other ways, is favorable to secured lenders, and it may well be that a receptive reaction to the whole will temper opposition to the "reasonable cause" deletion. Various proposals for mitigating the effect of the deletion are under consideration:

1) Reduce the time period during which a preference can occur from four months to possibly forty-five days.[30]
2) Insulate small transfers (*e.g.*, transfers of $1,000 or less) during the preferential period.[31]
3) Modify the "reasonable cause" requirement to create a presumption that the creditor had reasonable cause to believe the debtor to be insolvent upon a showing by the trustee that the debtor had made a preferential transfer during the crucial period.

B. When the Transfer Takes Place: the "Good Faith Purchaser" Test

In order to determine whether a particular transfer constitutes a preference, the point in time at which the transfer took place must be established.

---

[29] On the other hand, lenders might feel that an early abandonment of a troubled debtor might be imprudent simply because it might catapult the debtor immediately into bankruptcy with the result that transfers during the prior four month period might be struck down as preferences.

[30] This would involve a change in the definition of a preference (Section 60(a)(1)) and also in the definition of an act of bankruptcy (Section 3(b)).

[31] It is arguable that this modification accomplishes little, since under present practice such small transfers are rarely attacked by the trustee.

The present Bankruptcy Act makes this determination by providing certain acts of perfection which must occur in order for a transfer to be deemed to have taken place. Present Section 60(a)(2) sets forth two tests of perfection, one for real property and one for personal property. A transfer of real property is deemed to have taken place "when it became so far perfected that no subsequent bona fide purchase from the debtor could create rights in such property superior to the rights of the transferee." A transfer of personal property, on the other hand, is deemed to have occurred "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." The test for personal property is presently supplemented by Section 60(a)(6) which provides that certain equitable liens which may have been effective against a lien creditor are not sufficiently perfected to withstand the threat of preference.

The use of the "good faith purchaser" test for real property and the "lien creditor" test for personal property has complicated the verbiage of section 60 (*i.e.*, by making necessary much of the cumbersome language of Sections 60(a)(3), (4), and (5),[32] and has created legal problems as

---

[32] Section 60(a)(3): The provisions of paragraph (2) (governing the time of transfer) shall apply whether or not there are or were creditors who might have obtained such liens upon the property other than real property transferred and whether or not there are or were persons who might have become bona fide purchasers of such real property.

Section 60(a)(4): A lien obtainable by legal or equitable proceedings upon a single contract within the meaning of paragraph (2) is a lien arising in ordinary course of such proceedings upon the entry or docketing of a judgment or decree, or upon attachment, garnishment, execution, or like process, whether before, upon, or after judgment or decree and whether before or upon levy. It does not include liens which under applicable law are given a special priority over other liens which are prior in time.

Section 60(a)(5): A lien obtainable by legal or equitable proceedings could become superior to the rights of a transferee or a purchase could create rights superior to the rights of a transferee within the meaning of paragraph (2), if such consequences would follow only from the lien or purchase itself, or from such lien or purchase followed by any step wholly within the control of the respective lien holder or purchaser, with or without the aid of ministerial action by public officials. Such a lien could not,

well (*i.e.*, problems relating to the classification of fixtures, and other kinds of property possessing the characteristics of both realty and personalty.) Under the latest version of the Draft Amendments, the two tests have been replaced by a single "good faith purchaser" test for both real and personal property. According to this test, a transfer is deemed to have taken place when it has been perfected under applicable state law against subsequent purchasers of the property who are not entitled to "special priority." Purchasers entitled to special priority include (1) certain purchasers against whom a transferee cannot perfect under applicable state law (*i.e.*, a buyer in the ordinary course of trade, a holder in due course of negotiable instruments, a good faith purchaser of investment securities or negotiable documents of title or chattel paper, a holder of a purchase money security interest in goods or fixtures, or a lienor who has furnished services or materials with respect to the property) and (2) certain purchasers against whom the transferee could have perfected by taking further action, but did not (*i.e.*, a buyer of consumer goods or farm equipment under Section 9-307(2) of the Code). The substitution of this single test not only obviates the need for Subsections 60(a)(4), 60(a)(5) and part of 60(a)(3) but also eliminates problems of classification concerning fixtures.[33]

C. The Grace Period for Perfection

Under the present Bankruptcy Act, a transfer is deemed to have taken place when certain acts of perfection have been accomplished. Section 60(a)(7) provides a grace period for perfection: if the required acts of perfection are performed within the grace period, the transfer shall relate back to the time it actually took place. The length of this period depends upon the law of each state. If the applicable state law provides for a period of 21 days or less in which a particular act of perfection must take place in order for perfection to relate back to the time of the transfer, Section 60(a)(7) adopts the grace period provided by state law. If, on the other hand, the applicable state law does not provide a grace period or provides

> however, become so superior and such a purchase could not create rights for the purposes of paragraph (2) through any acts subsequent to the obtaining of such a lien or subsequent to such a purchase which require the agreement or concurrence of any third party or which require any further judicial action, or ruling.

[33] It might appear that the use of a bonafide purchaser test makes subsection 60(a)(6) expendable, since that subsection merely qualifies the present lien-creditor test for personal property. Yet Section 60(a)(6) is ultimately made expendable by the perfection requirements of Article 9, under which equitable liens cannot survive. If, for example, the Committee had used a single lien-creditor test instead of a bonafide purchaser test, present Section 60(a)(6) would still be unnecessary.

one which exceeds 21 days, Section 60(a)(7) applies a 21-day period.[34] Present Section 60(a)(8) supplements 60(a)(7) by providing that where no act of perfection is required by applicable state law (as in the case of certain automatically perfected security interests under the Code)[35] the transfer shall be deemed to have occurred at the time the transfer actually took place. In so doing the Bankruptcy Act recognizes the validity of such automatically perfected security interests.

The latest Draft of the proposed amendments carries forward, with one important change, the import of present Sections 60(a)(7) and 60(a)(8). The one difference is the substitution of a strict 21-day period which will not be cut back even though state law provides a shorter period. The argument that such a modification will encourage laxity in the perfecting of security interests seems to be adequately countered by the fact that the 21-day period is relevant only for the purposes of Section 60 and does not in any way insulate security interests from attack by liens and other competing interests.

D. Enabling Advances

Under the present Bankruptcy Act, a transfer within the four-month period will not be stigmatized as preferential to the extent it is made for new and contemporaneous consideration. Thus, an extension of credit or advance of funds made to enable a debtor to acquire inventory or equipment is generally insulated from attack as a preference.

The Draft Amendments in effect crystalize this protection by providing that there shall be no preference to the extent new value[36] is given pursuant to a properly perfected security agreement to enable a debtor to acquire property so long as the property is acquired within a reasonable period of time.

This proposal essentially incorporates the concept of a "purchase-money security interest" which appears in Article 9,[37] with the one significant variation that the proposal does not incorporate the requirement set forth in Section 9-107 that the proceeds of the advance to the debtor be "in fact so used" to purchase the property in which the security interest is taken. The Draft merely requires that the advance be made to enable the debtor to acquire the property within a reasonable time thereafter. What in fact

---

[34] The UCC is of course the "applicable state law" governing security interests in personal property in 49 states and the District of Columbia. Although the UCC generally does not provide a grace period for perfection (*cf.* purchase-money security interests in collateral other than inventory), the 21-day grace period supplied by Section 60(a)(7) is generally thought to apply. 2 GILMORE *supra,* note 2 at 1327.

[35] *See* UCC Section 9-302(1)(a)-(f).

[36] The term "new value" replaces the present term "new and contemporaneous consideration" and represents an attempt to mesh more closely the language of the UCC and the Bankruptcy Act.

[37] *See* UCC Section 9-107: Definitions: "Purchase-Money Security Interest."

constitutes a reasonable time is not defined in the Draft — presumably left open for judicial interpretation.

E. Set-off

Present Section 60(c) of the Bankruptcy Act provides the creditor with a right of set-off in the event that a preferential transfer is followed by an extension of unsecured credit to the debtor. It states:

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

One basic shortcoming of this provision, from the standpoint of the secured lender, is its requirement that the subsequent extension of credit be "without security of any kind." If a particular creditor has been preferred to the extent of $10,000, and thereafter advances $5,000 to the debtor secured by only $2,500 of collateral, there would be no set-off under Section 60(c) even though only half of the $5,000 advance was secured.

Dissatisfaction with this result has caused various members of the Committee to favor a revision of present Section 60(c). Under the present Draft a set-off rule has been included as part of the proposed Section 60(a). The Draft uses a more equitable "net result" formula, whereby an otherwise preferential transfer will be reduced by the amount by which subsequent advances exceed any contemporaneous consideration which secures those advances.

IV. Conclusion

The Draft Amendments emerge as a mixed blessing for secured lenders. On the one hand, the Amendments insulate certain security interests in after-acquired property from attack as preferences. On the other hand, this protection is cut short by an almost antiseptic two-point test. The position of secured lenders is further threatened by the proposed elimination of the "reasonable-cause-to-believe" requirement. Yet the success of the Draft Amendments is ultimately a political question, and the "give and take" approach of the Draft Amendments offers a politically realistic resolution of the "conflict" between Section 9-108 of the Uniform Commercial Code and Section 60 of the Bankruptcy Act.