Avoidance And Recovery Of Preferential Transfers
Under The United States Bankruptcy Code
(Title 11, Chapter 11, United States Code §§ 101 *et seq.*)

Preference Analysis Under The Bankruptcy Code

Introduction

Section 547(b) of the Bankruptcy Code, 11 U.S.C. §547(b), provides in pertinent part that:

The trustee may avoid any transfer of an interest of the debtor in property--

(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 was an insider; and

(5) that enables such creditor to receive more than such creditor would receive if--
(A) the case were a case under Chapter 7 of this title;
(B) the transfer had not been made; and
(C) such creditor received payment of such debt to the extent provided by the provisions of this title.

The purpose of Section 547(b) is two-fold: first, to promote the Bankruptcy Code's policy of equal distribution among the debtor's creditors; and second, to discourage creditors from unfairly pursuing collection efforts against an insolvent debtor at the expense of other creditors.[1] Because any debt collected within the "reachback period" (*i.e.,* ninety (90) days prior to bankruptcy, or one (1) year prior if the transferee is an "insider" of the debtor) may be recoverable for the benefit of the debtor's estate, creditors are less inclined to engage in overreaching collection practices on account of antecedent debts.

[1] "It is not the mere form or method of the transaction that the [former Bankruptcy Act, predecessor to the Bankruptcy Code] condemns, but the appropriation by the insolvent debtor of a portion of his property to the payment of a creditor's claim, so that thereby the estate is depleted and the creditor obtains an advantage over other creditors." *National Bank of Newport v. National Herkimer County Bank of Little Falls*, 225 U.S. 178, 32 S.Ct. 633, 56 L.Ed. 1042 (1912).

Elements of a Preferential Transfer under Section 547(b)

A. Element 1 - "Transfer"

"Transfer," as that term is used in the Bankruptcy Code, is defined in 11 U.S.C. § 101(54).[2] Nearly any act that undermines the underlying purpose of Section 547(b) (*i.e.*, to promote equality in distribution to creditors) may be deemed a "transfer" for the purpose of preference analysis. A transfer may be direct (payment to the creditor), indirect (payment by debtor to third party at direction and on behalf of mutual creditor), voluntary (debtor's transfer of collateral to bank to secure letter of credit for creditor's benefit), or involuntary (judgment lien).[3]

Not all judgments entered against the debtor within the applicable preference "reachback" period, however, are avoidable preferences. Section 547 generally affects only those judgments that create liens within the preference period. A judgment entered within the preference reach-back period arising out of the enforcement of a prior valid lien is not avoidable because there is no transfer of any interest in the debtor's property to the creditor; that is, the creditor was secured both before and after the judgment lien was created.

B. Element 2 - "Interest In The Property Of The Debtor"

The phrase "interest of the debtor in property" as used in Section 547(b) has been held to be equivalent to "property of the estate" as defined in 11 U.S.C § 541(A)(1); that is, property that would belong to the bankruptcy estate were it not for the transfer.[4] The fundamental inquiry for the purpose of preference analysis is whether the transfer diminished or depleted the fund that the creditor body as a whole can legally resort to for the payment of their debts.

Despite the expansive nature of the phrase "interest of the property of the debtor," several types of transfers are recognized as falling outside its reach. For example, payments made with the personal funds of a corporation's principal as a surety or guarantor of an obligation of the debtor is not a preferential transfer, because no interest in property of the debtor was transferred.[5]

Another notable exception is that of "earmarked" funds. "Earmarking" occurs when a third-party makes a loan to the debtor specifically to enable that debtor to satisfy the claim of a *designated* creditor. In such cases, even if the debtor actually takes possession of the loaned funds, courts nonetheless view the "earmarked" property as never having become part of the debtor's estate, so long

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[2] Section 101(54) of the Bankruptcy Code defines a "transfer" as "every mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with property or with an interest in property, including retention of title as a security interest and foreclosure of the debtor's equity of redemption." 11 U.S.C. § 101(54).

[3] *See In re XYZ Options, Inc.*, 154 F.3d 1276 (11th Cir. 1998) (judgment lien against the debtor's property is as much a "transfer" as obtaining consensual lien or security interest).

[4] *See Begier v. IRS*, 496 U.S. 53 (1990). Section 541 (a)(1) defines "property of the estate" as "all legal or equitable interests of the debtor on property as of the commencement of the [bankruptcy] case." 11 U.S.C. § 541(a)(1).

[5] *See Brown v. First National Bank*, 748 F.2d 490 (8th Cir. 1984).

as the loan was expressly conditioned upon the debtor's assent to pay a specific antecedent creditor.[6] As one court has stated:

> If all that occurs in a "transfer" is the substitution of one creditor for another, no preference is created because the debtor has not transferred property of his estate; he still owes the same sum to a creditor, only the identity of the creditor has changed.

Coral Petroleum, Inc. v. Banque Paribas-London, 797 F.2d 1351 (5th Cir. 1986).

However, a payment by the debtor with funds "earmarked" for a specified unsecured creditor will be avoidable as a preference to the extent that the new creditor receives a benefit unavailable to the existing creditor; *e.g.*, if the debtor was required to grant a security interest to the new lender. In this situation, the debtor's estate is diminished by the transfer of additional collateral.[7]

C. **Element 3 - "To or for the Benefit of a Creditor"**

Section 547 applies only to transfers to or for the benefit of creditors. Section 101(10) of the Bankruptcy Code defines "creditor" as an "entity that has a 'claim' against the debtor that arose at the time of or before the order for relief concerning the debtor." 11 U.S.C. § 101(10). Section 101(5) of the Bankruptcy Code, in turn, defines "claim" as:

> (a) right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured, or
>
> (b) right to an equitable remedy for breach of performance if such breach gives rise to a right to payment, whether or not such right to an equitable remedy is reduced to judgment, fixed, contingent, matured, unmatured, disputed, undisputed, secured, or unsecured.

11 U.S.C. § 101(5).

Transfers to or for the benefit of non-creditors, although not considered preferential, may otherwise be avoidable and recovered as fraudulent transfers. *See infra;* 11 U.S.C. §§ 544, 548.

Guarantors and sureties hold contingent claims against the debtor, and thus constitute "creditors" as defined under the Bankruptcy Code. Accordingly, any prepetition transfer that reduces the contingent liability of a guarantor, surety, endorser, or co-obligor is a transfer "for the benefit" of that creditor, even if the transfer is made to another party.[8] Prior to the 1994 amendments to the Bankruptcy Code, controversy existed as to whether payments made by the

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6 *See In re P.A. Bergner & Co. Holding Co.*, 187 B.R. 964 (Bankr. E.D. Wis. 1995)("earmarking" occurs only when a new creditor advances funds; the parties intend that those funds be used to pay an existing creditor; and payment to the existing creditor is a condition for obtaining the new credit).

7 *See In re Kelton Motors, Inc.*, 153 B.R. 417 (Bankr. D. Vt. 1993).

8 *See In re Robinson*, 6 F.3d 701 (10th Cir. 1993).

debtor to non-insider creditors, but which also benefited insider guarantors, were subject to the extended one-year reachback period applicable to insiders generally. *See, e.g.*, *Levit v. Ingersoll Rand Fin. Corp. (In re Deprizio)*, 874 F.2d 1186 (7th Cir. 1989).

In *Deprizio*, the debtor-corporation was liable to a non-insider creditor for obligations that were guaranteed by the debtor's president. In the period between 90 days and one year prior to the debtor-corporation filing bankruptcy, the debtor made payments to the creditor on this obligation. The court held that because the payments made to the non-insider creditor also benefited the insider guarantor, they were avoidable as preferences even though made outside of the 90-day reachback period applicable to non-insiders.

Due to the 1994 amendments to Section 550 of the Bankruptcy Code, however, non-insider transferees now have protection from preference liability as to any payments received between 90 days and one year prior to the debtor's bankruptcy filing, even if an insider guarantor also benefits from the transfer. As amended, Section 550 now provides:

> (c) If a transfer made between 90 days and one year before the filing of the petition --
>
> > (1) is avoided under section 547(b) of this title; and
> >
> > (2) was made for the benefit of a creditor that at the time of such transfer was an insider;
>
> the trustee may not recover under subsection (a) from a transferee that is not an insider.

11 U.S.C. § 550(c).

Thus, *Deprizio* was overturned by the amended Section 550(c), to the extent that payments made by the debtor between 90 days and one year prior to bankruptcy may no longer be recovered from a non-insider creditor, even if such payment benefits an insider guarantor. Note, however, that Section 550(c) of the Bankruptcy Code only protects non-insider transferees, and does not change the *Deprizio* court's ruling that insiders of the debtor may have preference liability for transfers or payments made to non-insider creditors between 90 days and one year prior to the petition date.

D. Element 4 - "For or On Account of an Antecedent Debt"

An "antecedent debt" is simply a pre-existing debt; that is, a debt that was owed and was incurred before the purportedly preferential transfer was made. *See Laws v. United Missouri Bank of Kansas City, N.A.*, 98 F.3d 1047 (8th Cir. 1996).[9] Thus, so long as the transfer is made after the debt comes into existence, the transfer is deemed to be made "for or on account of an antecedent debt."

Two categories of payments that generally are not considered to be "for or on account of an antecedent debt" are down payments and gifts or donations. A down payment is not a transfer for or on account of an antecedent debt if the payment is forfeitable and made prior to the time that the debtor

[9] A debt is incurred when the debtor becomes legally bound to pay. *Nolden v. Van Dyke Seed Co.*, 751 F.2d 1118 (9th Cir. 1985).

becomes legally obligated to pay the full contract amount. *See, e.g., Sullivan v. Willock*, 854 F.2d 196 (7th Cir. 1988).

With respect to gifts or donations, these types of transfers by definition are gratuitous and unrelated to any antecedent legally enforceable claim. Therefore, while a gift or donation may be recovered as a fraudulent transfer, it cannot constitute a preference under Section 547. *See Matter of Galbreath*, 207 B.R. 309 (Bankr. M.D. Ga. 1997).

E. Element 5 – "Made While The Debtor Was Insolvent"

In order for a transfer to be avoidable under Section 547 of the Bankruptcy Code, the transfer must be made while the debtor is "insolvent." Section 547(f) specifically provides that "[f]or the purposes of this section, the debtor is presumed to have been insolvent on and during the 90 days immediately preceding the date of the filing of the petition." 11 U.S.C. § 547(f).

The effect of Section 547(f) is to shift the burden of production on the issue of insolvency to the defendant in the preference action. Although the burden of proof remains on the party seeking to avoid the preference, Section 547(f) requires the defendant to present evidence that the debtor was not "insolvent," as that term is defined under Section 101(32) of the Bankruptcy Code, at the time the transfer was made. If the defendant can present some evidence of solvency during the applicable time period, then the party seeking to avoid the preference must meet it burden of proving that the debtor was insolvent on the date of the transfer. *See* 11 U.S.C. § 103(32).[10]

F. Element 6 - Within The Applicable Reachback Period

In order to be subject to avoidance as a preference, a transfer to a non-insider generally must be made "on or before 90 days before the date of the filing of the petition." 11 U.S.C. § 547(b)(4)(A).[11]

Pursuant to Section 547(b)(4)(B), a transfer to an "insider" may be avoided as a preference if it is made between ninety days and one year before the petition date. The purpose of this distinction is to prevent individuals or entities with inside knowledge of the debtor's circumstances from satisfying their own claims before those creditors unaware of the debtor's financial condition.

The definition of an "insider" can be found in Section 101(31) of the Bankruptcy Code:

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[10] Under Section 101(32)(A) of the Bankruptcy Code, a non-partnership, non-municipality debtor is "insolvent" when its liabilities exceed the fair market value of its nonexempt assets. While the "balance sheet" test also determines the solvency of a partnership, under Section 101(32)(B), a partnership cannot be "insolvent" if there is a solvent general partner. The operative test is whether after the general partners pay all of their non-partnership debts, is there enough non-exempt property left, together with partnership assets, to pay all of the partnership's debts. Finally, under Section 101(32)(C) of the Bankruptcy Code, a municipality is insolvent when it (i) generally is not paying its debts as they become due (unless such debts are the subject of a bona fide dispute); or (ii) is unable to pay its debts as they become due.

[11] Transfers which are made after the bankruptcy petition is filed may not be avoided as a preference. *Cate v. Nicely*, 656 F.2d 230 (6th Cir. 1981).

a. If the debtor is an individual --

an "insider" includes, but is not limited to, (i) a relative of the debtor or of a general partner of the debtor; (ii) a partnership in which the debtor is a general partner; (iii) a general partner of the debtor; (iv) a corporation in which the debtor is a director, officer, or person in control; and (v) a managing agent of the debtor.

b. If the debtor is a corporation --

an "insider" includes, but is not limited to, (i) a director or officer of the debtor; (ii) a person in control of the debtor; (iii) a partnership in which the debtor is a general partner; (iv) a general partner of the debtor; (v) a relative of a general partner, director, officer, or person in control of the debtor; and (vi) a managing agent of the debtor.

c. If the debtor is a partnership --

an "insider" includes, but is not limited to, (i) a general partner in the debtor; (ii) a relative of a general partner in, general partner of, or person in control of the debtor; (iii) a partnership in which the debtor is a general partner; (iv) a general partner of the debtor; (v) a person in control of the debtor; and (vi) a managing agent of the debtor.

11 U.S.C. §101(31).

For a transfer to be considered an avoidable preference during the extended reachback period for insiders, the creditor must have been an "insider" as defined by Section 101(31) on the exact date that the transfer was made. *See, e.g., Butler v. David Shaw, Inc.*, 72 F.3d 437 (4th Cir. 1996).

G. Element 7 - "Resulting In Greater Distribution Than Under Chapter 7"

Section 547(b)(5) requires the defendant-transferee to have received a greater percentage of its claim as a result of the allegedly preferential transfer than if the transfer had not been made and the defendant-transferee participated in the distribution of the estate's assets pursuant to a liquidation. Thus, Section 547(b)(5) requires a comparison between what the creditor actually receives and what it would have received under Chapter 7 to the extent provided under the applicable provisions of the Bankruptcy Code.

Under this rule, payments to a fully secured creditor during the 90-day reachback period generally will not be avoidable preferences because fully secured claims are satisfied before the claims of unsecured creditors in a Chapter 7 liquidation proceeding. In other words, such payments result in no prejudice to unsecured creditors, and the secured creditor is no better position than if the transfer had not been made and the debtor's assets liquidated. *See In re Griffith*, 194 B.R. 262 (E.D. Okla. 1996).

Transfers and payments to undersecured creditors, however, are presumed to have been applied first to the unsecured portion of the debt.[12] Therefore, a preference action may be brought to recover

[12] *See Drabkin v. A.I. Credit Corp.*, 800 F.2d 1153 (D.C. Cir. 1986); *In re Lease-A-Fleet, Inc.*, 151 B.R. 341 (Bankr. E.D. Pa. 1993).

transfers made to undersecured creditors to the same extent as unsecured creditors. *See In re Powerine Oil Co.*, 59 F3d 969 (9th. Cir. 1995).

<u>Defenses Preventing Avoidance Of A Preferential Transfer (11 U.S.C. §547(c))</u>

Section 547(c) of the Bankruptcy Code provides eight (8) statutory defenses to a preference action.

A. <u>Defense 1 - Contemporaneous Exchanges (11 U.S.C. §547(c)(1))</u>

Section 547(c) of the Bankruptcy Code provides, in relevant part:

> 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.

11 U.S.C. § 547(c).

This defense is the corollary to the requirement under Section 547(b)(2) that the transfer must have been made on account of an antecedent debt. If the transfer was made as a contemporaneous exchange for new value, then by definition, it could not have been made on account of an antecedent debt.

1. <u>Contemporaneous Exchange</u>.

Case by case analysis is required to determine whether a particular transaction involved a contemporaneous exchange for new value. First, the parties must <u>intend</u> that there be a contemporaneous exchange at the outset of the transaction. For example, if a bank makes an unsecured loan to a debtor and later learns that the debtor is having financial difficulties, any subsequent grant by the debtor of a security interest to the lender will not be considered a <u>contemporaneous</u> exchange – even if the loan is made and the lien granted a few hours apart on the same day. *See National City Bank of New York v. Hotchkiss*, 231 U.S. 50 (1913).

Next, under Section 547(c)(1)(B), the exchange must <u>in fact</u> be substantially contemporaneous. Recall that, for purposes of establishing whether a transfer occurred within the applicable reachback period under Section 547(b)(4), payments made by check are deemed "transfers" when the check is honored by the bank, not when it is delivered by the debtor to the creditor or tendered by the creditor to the bank. *See Barnhill v. Johnson*, 503 U.S. 393 (1992). However, for purposes of the "contemporaneous exchange" requirement of Section 547(c), transfers involving payment by check are normally deemed to have been made at be the time the check is <u>delivered</u> by the debtor, provided that the check is also negotiated and and honored within a "reasonable time" of the intended contemporaneous transfer. *See Matter of Locklin*, 101 F.3d 345 (5th Cir. 1996). If the check is dishonored or is tendered with delay, then there is no substantially contemporaneous exchange; rather, the transfer deemed to be in the nature of a credit transaction. *See In re Lee*, 179 B.R. 149 (9th Cir. B.A.P. 1995).

2. <u>**New Value Defined**</u>.

Section 547(a)(2) of the Bankruptcy Code defines "new value" as "money or money's worth in goods, services, or new credit, or release by a transferee of property previously transferred to such transferee." 11 U.S.C. § 547(a)(2). An intangible benefit does not constitute "new value"; *i.e.*, the value must be real and able to be reduced to a specific dollar figure. *See In re S.E.L. Maduro (Florida), Inc.*, 205 B.R. 987 (Bankr. S.D. Fla. 1997). Examples of new value include new credit, new goods or services, and the release of a lien or security interest.[13] Moreover, new value may be paid by a third party, so long as the debtor's estate is not otherwise diminished or depleted in connection with the transaction. *See Gulf Oil Corp. v. Fuel Oil Supply & Terminating, Inc.*, 837 F.2d 224 (5th Cir. 1988).

Transactions that do not confer "new value" include a creditor's forbearance from foreclosing on a security interest; settlement of a lawsuit in return for payment, and payment of a civil contempt fine.[14]

B. <u>**Defense 2 - Ordinary Course of Business (11 U.S.C. §547(c)(2))**</u>

Section 547(c) of the Bankruptcy Code provides, in relevant part:

> The trustee may not avoid under this section a transfer --
>
> (2) to the extent that such transfer was --
>
> (A) in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee;
>
> (B) made in the ordinary course of business or financial affairs of the debtor and the transferee; and
>
> (C) made according to ordinary business terms.

11 U.S.C. § 547(c)(2).

By exempting from preference actions payments and transfers made in the ordinary course of business, Section 547(c)(2) makes it more likely that only transfers resulting from unusual debt collection practices will be avoidable as preferences. Each element of Section 547(c)(2) must be satisfied in order for a creditor to prevail on an "ordinary course of business" defense.

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[13] *In re Kumar Bavishi & Assoc.*, 906 F.2d 942 (3rd Cir. 1990) (new credit); *In re H&S Transp. Co.*, 939 F.2d 355 (6th Cir. 1991) (new goods); *In re Maxwell Newspapers, Inc.*, 192 B.R. 633 (Bankr. S.D.N.Y. 1996)(new services); *In re Robinson Bros. Drilling, Inc.*, 877 F.2d 32 (10th Cir. 1989) (release of lien).

[14] *See, e.g., In re Valley Steel Products Co.*, 214 B.R. 202 (E.D. Mo. 1997); *Matter of Energy Co-op, Inc.*, 814 F.2d 1226 (7th Cir. 1987); *In re Mantelli*, 149 B.R. 154 (9th Cir. B.A.P. 1993).

1. Section 547(c)(2)(A) - Ordinary Course of Affairs

First, for a debt to have been incurred in the ordinary course of business or financial affairs of both the debtor <u>and</u> the transferee, as required by 11 U.S.C. § 547(c)(2)(A), the underlying debtor/creditor relationship must be normal and for ordinary purposes. The debtor and creditor need not have had a prior relationship in order for a debt to be incurred in the ordinary course of business; a first-time transaction may suffice. *See In re Speco Co.*, 218 B.R. 390 (Bankr. S.D. Ohio 1998).

2. Section 547(c)(2)(B) - Ordinary Course of Dealings

Next, in considering if a transfer was made in the ordinary course of dealings between the debtor and the creditor, as required by 11 U.S.C. § 547(c)(2)(B), courts look at whether the amount, timing and manner of payment were consistent with the parties' prior dealings This is known as the "subjective test," which considers what is normal between the parties, not what is normal in the relevant trade or industry. *See Barber v. Golden Seed Co.*, 129 F.3d 382 (7th Cir. 1997). For example, if a creditor generally accepts a late payment from the debtor without imposing any penalty, then the creditor's acceptance of a late payment within the preference reachback period may constitute a transfer made in the ordinary course of dealings. *See Lovett v. St. Johnsbury Trucking*, 931 F.2d 494 (8th Cir. 1991).

3. Section 547(c)(2)(C) - Ordinary Business Terms

Finally, under Section 547(c)(2)(C), the transfer must have been on "ordinary business terms." *See* 11 U.S.C. § 547(c)(2)(C). In establishing that a transfer was on "ordinary business terms," a creditor cannot merely demonstrate that the terms relating to the transfer were consistent with the creditor's own practices. Rather, the creditor must also present evidence of industry norms. This is known as the "objective test." *See In re A&W Assocs., Inc.*, 136 F.3d 1439 (11th Cir. 1998).

C. <u>Defense 3 - Purchase Money Security Interests (11 U.S.C. §547(c)(3))</u>

Section 547(c) of the Bankruptcy Code provides, in relevant part:

> The trustee may not avoid under this section a transfer --
>
> (3) that creates 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 the 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 on or before 20 days after the debtor received possession of such property.

11 U.S.C. 547(c).

Generally, this defense only applies to purchase money mortgagees or creditors that have made enabling loans for the debtor's purchase of personal property. *See, e.g., In re Alexander*, 219 B.R. 255 (Bankr. D. Minn. 1998). Under Section 547(c)(3), a creditor's security interest in specific collateral may not be avoided as a preference if (i) new value was given by or on behalf of the secured creditor; (ii) the new value was given to enable the debtor to acquire the collateral; and (iii) the new value was in fact used to acquire the collateral. This defense is available so long as the lender perfects the security interest within twenty (20) days after the debtor takes possession of the collateral, even if the debtor took title and signed the purchase contract more than 20 days prior to the lender's perfection of the security interest. *See In re B&B Utilities, Inc.,* 208 B.R. 417 (Bankr. E.D. Tenn. 1997).

D. Defense 4 - Transfer for Subsequent New Value (11 U.S.C. §547(c)(4))

Section 547(c) of the Bankruptcy Code provides, in relevant part:

> The trustee may not avoid under this section a transfer --
>
> (4) to or for the benefit of a creditor, to the extent that, after such transfer, such creditor gave new value to or for the benefit of the debtor --
>
> (A) not secured by an otherwise unavoidable security interest; and
>
> (B) on account of which new value the debtor did not make an otherwise unavoidable transfer to or for the benefit of such creditor.

11 U.S.C. § 547(c).

To prevail on this defense, a defendant-transferee must establish that (i) during the preference period, it gave new, unsecured value to or for the benefit of the debtor (*e.g*., an unsecured line of credit or an unsecured loan); and (ii) as of the petition date, the debtor had not repaid the new advances with an otherwise avoidable transfer. To the extent unpaid by the debtor, the creditor may offset the value of the new unsecured advances against any prior preferential transfers. *See In re Workboats Northwest, Inc.*, 201 B.R. 563 (Bankr. W.D. Wash. 1996).

The theory behind this defense is that, to the extent received by the debtor during the preference period, new value essentially "nets out" what otherwise would be avoidable preferences; *i.e.*, the creditor essentially "repaid" the estate in the courser of the reachback period. The purpose of this section is to encourage creditors to continue to extend unsecured credit to a financially troubled debtor.

E. Defense 5 - Security Interests in Inventory or Receivables (11 U.S.C. §547(c)(5))

Section 547(c) of the Bankruptcy Code provides, in relevant part:

> The trustee may not avoid under this section a transfer --

(5) that creates 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 by 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 interests for such debt on the later of --

(A) (i) with respect to a transfer to which subsection (b)(4)(A) of this section applies, 90 days before the date of the filing of the petition; or

(ii) with respect to a transfer to which subsection (b)(4)(B) of this section applies, one year before the date of the filing of the petition; or

(B) the date on which new value was first given under the security agreement creating the security interest.

In short, Section 547(c)(5) exempts from avoidance those security interests created within the preference reachback period as the result of a "floating lien" in inventory or receivables, except to the extent that there is a net improvement in the secured creditor's position that is prejudicial to the unsecured creditors.

When determining whether there has been a net improvement in the secured creditor's position, the value of the collateral is compared with the amount of the debt at two points in time. The first date is the beginning of the applicable reachback period (or the date within the preference period that the lender gave new value under the agreement creating the security interest). The second date is the petition date. <u>All interim fluctuations are ignored</u>. The transfer is avoidable only to the extent of any decrease in the unsecured deficiency of the creditor's secured claim between these two dates. In other words, if the value of the debtor's inventory increases from $500 to $600 during the relevant time period, yet there is no corresponding net improvement in the creditor's position (*e.g.*, from 50% to 60% secured) because it also made subsequent advances to the debtor, then no portion of the security interest is potentially avoidable.

Moreover, Section 547(c)(5) requires that unsecured creditors be <u>prejudiced</u> by any net improvement in the secured creditor's position. For example, if the creditor has a floating lien on all of the debtor's assets or inventory, then unsecured creditors are not prejudiced even if the secured creditor's position improves between the two relevant dates by virtue of a market value increase in the collateral (as opposed to new credit purchases). *See In re Castleton's Inc.*, 990 F.2d 551 (10th Cir. 1993). Similarly, if a creditor is fully secured at the outset of the applicable reachback period, then there can be no improvement in its position because no deficiency claim existed on the initial date.

F. <u>Defense 6 - Statutory Liens (11 U.S.C. §547(c)(6))</u>

Section 547(c) of the Bankruptcy Code provides, in relevant part:

The trustee may not avoid under this section a transfer --

> (6) that is the fixing of a statutory lien that is not avoidable under Section 545 [of the Bankruptcy Code].

11 U.S.C. § 547(c)(6).

A statutory lien is one that arises solely by statute and does not include consensual security interest or judgment liens. Section 101(53) of the Bankruptcy Code defines a "statutory lien" as a "lien arising solely by force of a statute on specified circumstances or conditions, or lien of distress for rent, whether or not statutory, but does not include a security interest or judicial lien, whether or not such interest or lien is provided by or is dependent on a statute and whether or not such interest or lien is made fully effective by statute." 11 U.S.C. § 101(53).

By its language, Section 547(c)(6) only applies to the "fixing" of a statutory lien. 11 U.S.C. § 547(c)(6). Therefore, payments made in satisfaction of valid statutory liens are not excepted under Section 547(c)(6) and may be recovered as a preference. *See e.g., Daniel v. United States Dept. of Treasury*, 42 B.R. 908 (Bankr. D. Nev. 1984). However, payments made by the debtor to a creditor for the purpose of preventing the <u>imposition</u> of a statutory lien are protected under Section 547(c)(6). *See Cimmaron Oil Co. v. Cameron Consultants, Inc.*, 71 B.R. 1005 (N.D. Tex. 1987).

G. <u>Defense 7 - Alimony, Maintenance and Support (11 U.S.C. §547(c)(7))</u>

Section 547(c) of the Bankruptcy Code provides, in relevant part:

> The trustee may not avoid under this section a transfer --
>
> (7) to the extent such transfer was a bona fide payment of a debt to a spouse, former spouse, or child of the debtor, for alimony to, maintenance for, or support of such spouse or child, in connection with a separation agreement, divorce decree or other order of a court of record, determination made in accordance with State or territorial law by a governmental unit, or property settlement agreement, but not to the extent that such a debt --
>
> (A) is assigned to another entity, voluntarily, by operation of law, or otherwise; or
>
> (B) includes a liability designated as alimony, maintenance, or support, unless such liability is actually in the nature of alimony, maintenance or support.

H. <u>Defense 8 - Small Transfer Consumer Debts (11 U.S.C. §547(c)(8))</u>

Section 547(c) of the Bankruptcy Code provides, in relevant part:

> The trustee may not avoid under this section a transfer --
>
> (8) if, in a case filed by an individual debtor whose debts are primarily consumer debts, the aggregate value of all property that constitutes or is affected by such transfer is less than $600.

The purpose of this section is to prevent the pursuit of preference litigation for small recoveries that would only marginally, if at all, benefit the estate.