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# "Value" Judgments: Accounts Receivable Financing and Voidable Preferences Under the New Bankruptcy Code

Neil B. Cohen\*

## I. INTRODUCTION

The enactment of the Bankruptcy Reform Act of 1978,<sup>1</sup> replacing prior bankruptcy law with a new bankruptcy code (the Code), has significantly changed the law governing accounts receivable financing.<sup>2</sup> The new Code has broadened the bankruptcy trustee's power to avoid a lender's security interest in accounts receivable on grounds that the security interest constitutes a voidable preference. Under the Code, the determination of a voidable preference depends upon a comparison of the

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1. Pub. L. No. 95-598, § 101, 92 Stat. 2549 (codified at 11 U.S.C. §§ 1-1160 (Supp. IV 1980)).

2. Accounts receivable financing is a major source of funds utilized by businesses that sell their goods or services on open account, and that need cash for their operations prior to payment of such accounts. See Reisman, *The Challenge of the Proposed Bankruptcy Act to Accounts Receivable and Inventory Financing of Small to Medium-Sized Business*, 83 COM. L.J. 169, 175-77 (1978). Although, on occasion, a financial institution will make a simple loan to a business and take as collateral certain currently existing accounts receivable of that business, the typical financing arrangement is more complex, differing from the simple collateralized loan in two respects. First, the typical accounts receivable financing arrangement is one of revolving credit. That is, the business may borrow additional amounts of money frequently without the necessity of negotiating a new loan, so long as the aggregate loans outstanding do not exceed a certain percentage, usually 60%-80%, of the face amounts of outstanding "eligible" receivables. As debtors pay these receivables, the business repays the aggregate loan from the proceeds. The repayments are not matched, however, to particular loans. *Id.* More importantly, the typical receivables loan is secured not only by all then-existing accounts receivable of the borrower, but also by all future accounts receivable of the borrower. Thus, each receivable of the borrower is collateral not only for the loan which it enabled, but also for all past and future loans. Since the security interest "floats" over all receivables of the borrower, this type of security interest is often called a "floating lien." See, e.g., J. WHITE & R. SUMMERS, *HANDBOOK OF THE LAW UNDER THE UNIFORM COMMERCIAL CODE* 1007 (2d ed. 1980).

"value"<sup>3</sup> of the accounts receivable at two different times.<sup>4</sup> The Code, however, fails to define "value." This omission has caused great uncertainty for accounts receivable financiers.

This uncertainty is significant because it affects the availability of collateral if the borrower does not satisfy the underlying obligation. Creditors consider the availability of collateral an important factor in determining the terms of a loan; indeed, the availability of collateral often determines whether a lender will extend credit at all.<sup>5</sup> Moreover, a rational creditor, considering the availability of collateral as protection against a defaulting debtor, will assess the prospects of recovery both from the debtor and, in the event of the debtor's bankruptcy, from the bankruptcy trustee. The trustee's power to avoid security interests in accounts receivable is therefore an issue of great practical concern. To assess the vitality of these security interests, and to evaluate the definition of "value" under the Code, it is important to contrast the rights of secured creditors under the prior bankruptcy law with their rights under current law. Although the Code's treatment of security interests in inventory and receivables is identical, the treatment of receivables raises a more acute definitional problem. Hence the focus of this Article is on receivables financing, although much of the general analysis applies equally to inventory financing.

## II. TREATMENT UNDER THE 1898 ACT

Prior to the new Code, the Bankruptcy Act of 1898,<sup>6</sup> as amended<sup>7</sup> (the 1898 Act), generated considerable controversy concerning the effectiveness of a floating lien<sup>8</sup> on receivables or

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3. See 11 U.S.C. § 547(c)(5) (Supp. IV 1980); notes 70-86 *infra* and accompanying text.

4. See notes 65-69 *infra* and accompanying text.

5. See, e.g., *Bankruptcy Act Revision: Hearings on H.R. 31 & H.R. 32 Before the Subcomm. on Civil and Constitutional Rights of the House Comm. on the Judiciary*, 94th Cong., 1st & 2d Sess. 1739-40 (1975-76) (statement of Franklin Cole, Chairman of the Board of Walter Heller & Co.). Cf. Jackson & Kronman, *Voidable Preferences and Protection of the Expectation Interest*, 60 MINN. L. REV. 971, 988-89 (1976) (allowing a trustee in bankruptcy to use the avoiding power to circumvent a secured creditor's bargained-for priorities could conceivably lead to the eradication of the lender's security interest as a source of collateral); Note, *Preferential Transfers and the Value of the Insolvent Firm*, 87 YALE L.J. 1449, 1459 n.67 (1978) (eliminating "the possibility of securing an antecedent debt during insolvency [could] result in more bankruptcies, since lenders unwilling to continue their support on an unsecured basis . . . would then have no option but to file against the debtors.").

6. Bankruptcy Act of July 1, 1898, ch. 541, 30 Stat. 544.

7. See, e.g., Act of July 22, 1938, ch. 575, 52 Stat. 840.

8. See note 2 *supra*.

inventory with respect to receivables or inventory created or acquired during the period preceding bankruptcy.<sup>9</sup> The secured creditors, of course, sought to apply this collateral to the debts owed to them, while trustees attacked the validity of the creditors' security interests in order to increase the size of the estate.

The heart of the trustees' attack on floating liens was the doctrine of voidable preferences. Pursuant to section 60a of the 1898 Act, a preference was a transfer

of any of the property of a debtor to or for the benefit of a creditor for or on account of an antecedent debt, made or suffered by such debtor while insolvent and within four months before the filing by or against him of the petition in bankruptcy . . . 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.<sup>10</sup>

Section 60b of the 1898 Act further provided that a trustee could avoid such a preference and recover the transferred property if the creditor, at the time of transfer, had reasonable cause to believe that the debtor was insolvent.<sup>11</sup> Seeking to augment their debtors' estates, bankruptcy trustees frequently attempted to avoid claims of secured creditors to accounts receivable or inventory which had come into existence during the four months before bankruptcy.<sup>12</sup> The trustees argued that the debtor could not transfer property until it came into existence and, therefore, that no account receivable was transferred until such time. Thus, accounts coming into existence during the four

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9. See, e.g., Friedman, *The Bankruptcy Preference Challenge to After-Acquired Property Clauses Under the Code*, 108 U. PA. L. REV. 194 (1959); Gordon, *The Security Interest in Inventory Under Article 9 of the Uniform Commercial Code and the Preference Problem*, 62 COLUM. L. REV. 49 (1962); Henson, *The Interpretation of the Uniform Commercial Code: Article 9 in the Bankruptcy Courts*, 22 U. MIAMI L. REV. 101 (1967); Hogan, *Games Lawyers Play With the Bankruptcy Preference Challenge to Accounts and Inventory Financing*, 53 CORNELL L. REV. 553 (1968); Hogan, *Future Goods, Floating Liens, and Foolish Creditors*, 17 STAN. L. REV. 822 (1965); Kennedy, *The Trustee in Bankruptcy Under the Uniform Commercial Code: Some Problems Suggested by Articles 2 and 9*, 14 RUTGERS L. REV. 518 (1960); King, *Section 9-108 of the Uniform Commercial Code: Does It Insulate the Security Interest From Attack by a Trustee in Bankruptcy?*, 114 U. PA. L. REV. 1117 (1966); Krause, Kripke & Seligson, *The Code and the Bankruptcy Act: Three Views on Preferences and After-Acquired Property*, 42 N.Y.U. L. REV. 278 (1967); Riemer, *Bankruptcy-Preference-Conflict between Section 9-108 of Uniform Commercial Code and Section 60(a) of Bankruptcy Act*, 70 COM. L.J. 63 (1965); Viles, *The Uniform Commercial Code v. the Bankruptcy Act*, 55 KY. L.J. 636 (1967).

10. Bankruptcy Act of July 1, 1898, ch. 541, 30 Stat. 544, as amended by Act of June 22, 1938, Pub. L. No. 75-696, § 60a, 52 Stat. 840.

11. *Id.* § 60b.

12. See, e.g., *DuBay v. Williams*, 417 F.2d 1277 (9th Cir. 1969), and cases cited therein.

month period preceding bankruptcy were transferred during that period for antecedent debts.<sup>13</sup>

In a series of cases<sup>14</sup> beginning in 1967—*Rosenberg v. Rudnick*,<sup>15</sup> *Grain Merchants of Indiana, Inc. v. Union Bank and Savings Co.*,<sup>16</sup> and *DuBay v. Williams*<sup>17</sup>—the federal courts rejected the trustees' argument as applied to receivables and inventory financing under the Uniform Commercial Code (U.C.C.).<sup>18</sup> These cases cited a variety of policy grounds and inventive doctrines to justify their refusal to allow the trustee to avoid the security interests,<sup>19</sup> but common to all these cases

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13. See, e.g., *id.* at 1287.

14. These cases all involved debts governed by states' enactments of the 1962 version of the Uniform Commercial Code.

15. 262 F. Supp. 635 (D. Mass. 1967).

16. 408 F.2d 209 (7th Cir.), *cert. denied*, 396 U.S. 827 (1969).

17. 417 F.2d 1277 (9th Cir. 1969).

18. 417 F.2d at 1287-88; 408 F.2d at 212-13; 262 F. Supp. at 638-39.

19. The cases raised three theories supporting the secured creditors' claims which have practical appeal, but which are at best only subsidiary arguments. First among these theories is the "entity" or "Mississippi River" theory. Under this theory, individual accounts receivable and items of inventory are not discrete items of collateral, but, rather, are parts of one large res ("inventory" or "receivables") which is the collateral. See 417 F.2d at 1287 n.8; 408 F.2d at 216; 262 F. Supp. at 639. Thus, assuming that the security interest was originally granted more than four months before bankruptcy, although individual components of the entity known as inventory or receivables may have become part of that mass during the four months preceding bankruptcy, the security interest in the mass itself was transferred before that period and, therefore, cannot constitute a preference. Professor Henson has popularized this theory under the rubric of the "Mississippi River" theory, pointing out that a hypothetical creditor who took a security interest in the Mississippi River and filed appropriate financing statements more than four months before bankruptcy should not be deprived of that collateral upon bankruptcy merely because some of the water in the river was not part of the river four months earlier, and some water which had been part of the river four months earlier was no longer in the river. See, e.g., R. HENSON, *HANDBOOK ON SECURED TRANSACTIONS UNDER THE UNIFORM COMMERCIAL CODE* 281-82 n.57 (2d ed. 1979). Though this argument has some appeal, it reveals some deficiencies upon close analysis. In particular, it does not account for changes in the water level of the river. In other words, it does not justify upholding a security interest in a res which has increased in size.

The second theory raised in these cases, closely related to the entity theory, is known as the "substitution of collateral" doctrine. Under this theory, inventory and receivables coming into the debtor's possession during the last four months function as substitutes for the inventory bought prior to the four month period and sold within it and accounts created outside the period and collected within it. 408 F.2d at 217. See also R. HENSON, *supra*, at 281, 289. The doctrine, however, does not account for collateral received in the four month period in excess of collateral liquidated in that span.

Finally, these cases rely on a controversial section of the U.C.C. to insulate receivables and inventory financing from attack. U.C.C. § 9-108 provides that when a secured party makes an advance

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

was a single interpretation of the relevant statutes.<sup>20</sup> The courts' interpretations all relied, at least in part, on the clear definition in the 1898 Act of the moment at which a transfer was deemed to take place. Subsection 60a(2) of the 1898 Act provided that

a transfer of property other than real property shall be deemed to have been made or suffered at the time when it became so far perfected that no subsequent lien upon such property obtainable by legal or equitable proceedings on a simple contract could become superior to the rights of the transferee.<sup>21</sup>

Under the U.C.C., a creditor's security interest in after-acquired collateral is not perfected until it attaches,<sup>22</sup> and attachment does not occur until the debtor has rights in the collateral.<sup>23</sup> Thus, a security interest in an account receivable which does not yet exist, and, accordingly, in which the debtor—the account creditor—does not yet have rights, has not attached and is not perfected.

As the Seventh Circuit reasoned in *Grain Merchants*, however, once a secured creditor files a financing statement with respect to a floating lien on receivables or inventory, no subsequent lien creditor can achieve priority over the secured creditor, even though the security interests with respect to after-acquired collateral are not yet perfected.<sup>24</sup> In the case of a perfected floating lien on inventory or receivables, therefore, no voidable preference can result as long as the financing statement was filed more than four months before bankruptcy, since

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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.

As the official comments indicate, the purpose of section 9-108 is to insulate after-acquired collateral, such as inventory and receivables, from attack as voidable preferences. *Id.* at Comment 1. Although by its terms section 9-108 would seem to achieve that result, there is a significant problem involved in applying the section. Subsection 60a(2) of the Bankruptcy Act of July 1, 1898, ch. 541, 30 Stat. 544, as amended by Act of June 22, 1938, Pub. L. No. 75-696, 52 Stat. 840, specifically defined the moment a transfer was deemed to be made for the purposes of voidable preference analysis. Inasmuch as the Bankruptcy Act of 1898 was a federal statute and section 9-108 is, where enacted, a state statute, by virtue of the supremacy clause of the Constitution of the United States, U.S. CONST. art. VI, cl. 2, any inconsistency would be resolved by giving effect to the Bankruptcy Act if inconsistent with the U.C.C.

20. 417 F.2d at 1287; 408 F.2d at 212-13; 262 F. Supp. at 637-38.

21. Bankruptcy Act of July 1, 1898, ch. 541, 30 Stat. 544, as amended by Act of June 22, 1938, Pub. L. No. 75-696, § 60a, 52 Stat. 840.

22. See U.C.C. § 9-303.

23. See U.C.C. § 9-203 (1972 version); U.C.C. § 9-204 (1962 version).

24. 408 F.2d at 212-13. See also *DuBay v. Williams*, 417 F.2d at 1287-88.

the transfers of security interests are deemed to have taken place at the time of filing.<sup>25</sup> This analysis of the 1898 Act, although widely debated among commentators, became dominant in the courts.<sup>26</sup>

### III. TREATMENT UNDER THE BANKRUPTCY CODE

A significant change in the principles governing the validity in bankruptcy of floating liens in inventory and receivables was developing even before *Rosenberg*, *Grain Merchants*, and *DuBay*. In 1966, the National Bankruptcy Conference established the Committee on Coordination of the Bankruptcy Act and the Uniform Commercial Code, chaired by Professor Grant Gilmore (the Gilmore Committee).<sup>27</sup> The Gilmore Committee proposed significant changes in section 60a of the 1898 Act<sup>28</sup> which became the basis of section 4-607 proposed by the Commission on Bankruptcy Laws of the United States.<sup>29</sup> This proposal has survived largely intact as section 547 of the Code,<sup>30</sup> albeit with significant tinkering and rewriting.

When the Gilmore Committee began its inquiry in 1966, it was primarily concerned with the possibility that no after-acquired security interests in receivables or inventory would survive a trustee's attack. Thus, an initial goal of the Gilmore Committee was to grant greater protection to inventory and receivables financiers.<sup>31</sup> The advent of *Rosenberg*, *Grain Merchants*, and *DuBay*, however, rendered the Committee's proposals and the eventual statute more restrictive than section 60a as ultimately interpreted. An examination of the operation of section 547 with respect to receivables financing is essential to determine the extent of the new limits on the abil-

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25. This analysis applies even though the security interests were not perfected, and indeed, the collateral did not even exist until much later.

26. See, e.g., *Biggins v. Southwest Bank*, 490 F.2d 1304, 1309 (9th Cir. 1973); *Speciner v. American Nat'l Bank & Trust*, 471 F. Supp. 549, 551-52 (E.D.N.Y. 1978), *aff'd*, 600 F.2d 5 (2d Cir. 1979). See also, e.g., NATIONAL BANKRUPTCY CONFERENCE, REPORT OF THE COMMITTEE ON THE COORDINATION OF THE BANKRUPTCY ACT AND THE UNIFORM COMMERCIAL CODE (1970), reprinted in H.R. REP. NO. 595, 95th Cong., 2d Sess. 204, 207-08, and in [1978] U.S. CODE CONG. & AD. NEWS 6164, 6167-68; Harrington, *Insecurity for Secured Creditors—The Floating Loan and Section 547 of the Bankruptcy Act*, 63 MARQ. L. REV. 447, 466 (1980).

27. H.R. REP. NO. 595, 95th Cong., 2d Sess. 204, reprinted in [1978] U.S. CODE CONG. & AD. NEWS 6164, 6167-69.

28. *Id.* at 209-10, reprinted in [1978] U.S. CODE CONG. & AD. NEWS at 6169-70.

29. See REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, H. R. DOC. NO. 137, 93d Cong., 1st Sess., pt. II at 166-75 (1973).

30. 11 U.S.C. § 547 (Supp. IV 1980).

31. See note 27 *supra*.

ity of receivables and inventory creditors to retain effective security interests after bankruptcy.<sup>32</sup>

Section 547(b)<sup>33</sup> of the Code contains the five elements of a voidable preference.<sup>34</sup> According to section 547(b):

Except as provided in subsection (c) of this section, the trustee may avoid any transfer of property of the debtor—

- (1) to or for the benefit of a creditor;
- (2) for or on account of an antecedent debt owed by the debtor before such transfer was made;
- (3) made while the debtor was insolvent;
- (4) made—
  - (A) on or within 90 days before the date of the filing of the petition; or
  - (B) between 90 days and one year before the date of the filing of the petition, if such creditor, at the time of such transfer—
    - (i) was an insider; and
    - (ii) had reasonable cause to believe the debtor was insolvent at the time of such transfer; and
- (5) that enables such creditor to receive more than such creditor would receive if—
  - (A) the case were a case under chapter 7 of this title;
  - (B) the transfer had not been made; and
  - (C) such creditor received payment of such debt to the extent provided by the provisions of this title.<sup>35</sup>

The first element of a preference—to or for the benefit of a creditor—is clearly satisfied by the granting of a security interest in accounts receivable to a lender, since the lender is by definition a creditor.<sup>36</sup>

The second element—for an antecedent debt owed before the transfer—is a key element in any financing arrangement, including accounts receivable financing, involving security interests in after-acquired property. To determine whether a transfer was made for an antecedent debt, one must first determine when that transfer was made. Subsection 547(e)(2)<sup>37</sup> determines the time at which a transfer of property is deemed to be made for the purpose of section 547 analysis.<sup>38</sup> It provides:

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

- (A) at the time such transfer takes effect between the transferor and

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32. For a broader analysis of the operation of section 547, see 4 L. KING, COLLIER ON BANKRUPTCY ¶ 547 (15th ed. 1979).

33. 11 U.S.C. § 547(b) (Supp. IV 1980).

34. "If any one of the elements of a preference . . . is wanting, a preference under [section] 547 has not been established." 4 L. KING, *supra* note 32, at ¶ 547.11 n.21. *Accord, In re Suppa*, 8 B.R. 720, 722 (Bankr. D.R.I. 1981).

35. 11 U.S.C. § 547(b) (Supp. IV 1980).

36. *See id.* § 101(9).

37. *Id.* § 547(e)(2).

38. *See, e.g., In re Meritt*, 7 B.R. 876, 878 (Bankr. W.D. Mo. 1980).



- the transferee, if such transfer is *perfected* at, or within 10 days after, such time;
- (B) at the time such transfer is *perfected*, if such transfer is *perfected* after such 10 days; or
- (C) immediately before the date of the filing of the petition, if such transfer is *not perfected* at the later of
- (i) the commencement of the case; and
  - (ii) 10 days after such transfer takes effect between the transferor and the transferee.<sup>39</sup>

The time of a transfer thus depends on the moment the transfer is perfected.

Subsection 547(e)(1)(B)<sup>40</sup> indicates that a transfer of personal property, including accounts receivable, is deemed perfected<sup>41</sup> for purposes of subsection (e)(2) "when a creditor on a simple contract cannot acquire a judicial lien that is superior to the interest of the transferee."<sup>42</sup> This test for perfection is substantively identical to the definition of time of transfer appearing in section 60a(2) of the 1898 Act.<sup>43</sup> As the *Grain Merchants* and *DuBay* cases demonstrated, once a creditor files a financing statement covering a security interest in after-acquired collateral, no judicial lien creditor may be superior to the secured creditor.<sup>44</sup> Therefore, pursuant to subsection 547(e)(1)(B), a security interest in after-acquired accounts receivable is perfected for bankruptcy purposes when the creditor files a properly completed financing statement.

Reading subsection 547(e)(2) with this understanding of perfection, it is apparent that when a financing statement is filed within ten days after the security interest is created,<sup>45</sup> subsection (e)(2)(A) determines the moment at which the transfer is deemed to take place. The rule of subsection (e)(2)(A) indicates that, subject to subsection (e)(3), a transfer is deemed to have taken place "at the time such transfer takes effect between the transferor and transferee."<sup>46</sup> Accordingly, a transfer of a security interest in after-acquired accounts

39. 11 U.S.C. § 547(e)(2) (Supp. IV 1980) (emphasis added).

40. *Id.* § 547(e)(1)(B). See *In re Durkay*, 9 B.R. 58, 62 (Bankr. N.D. Ohio 1981).

41. Section 547(e)(1) is similar, but not identical, to the U.C.C. definition of perfection. Compare 11 U.S.C. § 547(e)(1) (Supp. IV 1980) with U.C.C. §§ 9-302-9-306 (1977).

42. 11 U.S.C. § 547(e)(1)(B) (Supp. IV 1980).

43. See text accompanying note 21 *supra*.

44. See notes 22-26 *supra* and accompanying text.

45. This should, of course, occur in all competently administered transactions. See C. FUNK, BANKS AND THE UNIFORM COMMERCIAL CODE 36 (2d ed. 1964).

46. 11 U.S.C. § 547(e)(2)(A) (Supp. IV 1980).

receivable takes place at the creation of the security interest. Therefore, if the indebtedness does not predate the creation of the security interest, the transfer is not for an antecedent debt.

The rule of subsection (e)(2) is subject, however, to the exception in subsection (e)(3) that "[f]or the purposes of [section 547] a transfer is not made until the debtor has acquired rights in the property transferred."<sup>47</sup> The debtor who has extended credit on account cannot have rights in an account receivable until the account exists. Thus, pursuant to subsection (e)(3), security interests in accounts receivable that come into existence after the initial extension of the secured credit by the lender to the account creditor are not deemed transferred until such accounts come into existence, and thus after the creation of the debt secured thereby.<sup>48</sup> The transfers are, accordingly, "for or on account of an antecedent debt owed by the debtor before such transfer was made."<sup>49</sup> The second element of a preferential transfer is therefore satisfied.

The third element of a preferential transfer—occurrence while the debtor was insolvent—depends on the above analysis of the timing of the transfer. Since a transfer of a security interest in an account receivable is not deemed to have occurred until the creation of the receivable, the third element of a preference is satisfied if the debtor was insolvent<sup>50</sup> at the time the account receivable was created. It is important in this regard to note that section 547(f)<sup>51</sup> creates a presumption that a debtor was insolvent during the ninety days prior to the filing of the bankruptcy petition.

The fourth element—transfer within the statutory time period—is also dependent on the determination of the time of transfer. In cases in which the transferee was not an insider<sup>52</sup> with cause to believe that the debtor was insolvent, a transfer fulfills this criterion of voidability if it was made "on or within 90 days before the date of the filing of the petition."<sup>53</sup> Since,

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47. *Id.* § 547(e)(3).

48. *Cf. In re Cox*, 10 B.R. 268, 271 (Bankr. D. Md. 1981) (transfer does not occur until debtor has rights in collateral).

49. 11 U.S.C. § 547(b)(2) (Supp. IV 1980).

50. The Code uses a modified balance sheet approach to insolvency. *See id.* § 101(26).

51. Section 547(f) provides that: "For 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." *Id.* § 547(f).

52. For the definition of insider, see *id.* § 101(25).

53. *Id.* § 547(b)(4)(A). In cases in which the transferee was an insider with cause to believe that the debtor was insolvent, the time period is extended to one year. *Id.* § 547(b)(4)(B).

pursuant to section 547(e), the transfer of a security interest in an account receivable is not deemed to occur until that receivable comes into existence,<sup>54</sup> security interests with respect to receivables which come into existence within the ninety day period prior to the filing of a petition will necessarily fulfill this fourth criterion.

The fifth element—improvement over the creditor's share of a Chapter 7 distribution<sup>55</sup>—invites complex calculations. As Professors White and Summers have observed, however, it is an element that will virtually always be fulfilled if the transfer satisfies the first four elements of section 547(b), since the assets of the bankrupt estate are usually insufficient to fully satisfy the claims of all creditors.<sup>56</sup>

A typical accounts receivable financing arrangement illustrates the application of section 547(b). Assume that the First National Bank entered into an arrangement with Failing Industries on January 1, pursuant to which First National Bank would loan funds to Failing Industries secured by a security interest in all present and future accounts receivable of the company. Assume in addition that Failing Industries filed a bankruptcy petition on July 5. Finally, assume that all the accounts receivable owned by Failing Industries on July 5 resulted from sales occurring within the previous ninety days. The vitality of First National Bank's claim to the accounts receivable of Failing Industries depends in part on whether the trustee can avoid, as a preference, the security interest in any of the accounts receivable.

To establish a voidable preference, the elements of section 547(b) must be satisfied. The First National Bank is a creditor of Failing Industries,<sup>57</sup> and the granting of a security interest is a transfer;<sup>58</sup> therefore, Failing Industries has made a transfer to a creditor. In addition, the transfer is for an antecedent debt. The debt secured by the accounts receivable was created on

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54. *Id.* § 547(e)(3).

55. *Id.* §§ 701-766. Under Chapter 7, the trustee liquidates all of the debtor's nonexempt assets and distributes the proceeds to the creditors on a pro rata basis in the order of their priority. *See id.* § 726.

56. *See* J. WHITE & R. SUMMERS, HANDBOOK OF THE LAW UNDER THE UNIFORM COMMERCIAL CODE 875 (1st ed. 1972) (discussing § 60a of the 1898 Act). *See also In re Dennis*, BANKR. L. REP. (CCH) ¶ 68,297 (7th Cir. 1981) for an insightful analysis of this problem.

57. *See* note 36 *supra* and accompanying text.

58. 11 U.S.C. § 101(40) (Supp. IV 1980) defines "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." (emphasis added).

January 1. All of the accounts receivable which served as collateral on July 5 came into existence during the ninety days prior to July 5. Pursuant to the time-of-transfer rules of section 547(e),<sup>59</sup> the security interests were deemed transferred to the First National Bank during that period, and were therefore transferred for a preexisting debt. Moreover, section 547(f)<sup>60</sup> provides that Failing Industries was presumptively insolvent during the ninety-day period preceding the filing of its bankruptcy petition. Since the transfer of the security interests in the receivables occurred when the receivables were created—during the ninety days before the petition was filed—the transfers were made while the debtor is presumed to have been insolvent. The time-of-transfer rules also establish that the transfers occurred within ninety days preceding the filing of the bankruptcy petition. Finally, assuming that the assets of Failing Industries are insufficient to pay unsecured creditors as fully as the First National Bank, the security interest in the receivables would enable the First National Bank to receive a greater portion of the amount owed to it than it would receive under Chapter 7. Thus, all five criteria of section 547(b) are satisfied.

Satisfaction of the section 547(b) criteria does not, however, ensure that the trustee can avoid the security interests of First National Bank in the accounts receivable of Failing Industries. Section 547(b) states that fulfillment of all five criteria creates a voidable preference "except as provided in subsection (c)."<sup>61</sup> Section 547(c)<sup>62</sup> must therefore be examined in order to determine whether the security interests survive the trustee's attack.

Section 547(c) describes six types of transfers which, although falling within the criteria of section 547(b), are not voidable by the trustee. The exception relevant to receivables financing appears in subsection 547(c)(5),<sup>63</sup> which significantly limits the reach of section 547(b) with respect to security interests in accounts receivable and inventory. Although section 547(b) would declare all such security interests in accounts arising after the initial advance of funds and within ninety days before bankruptcy to be preferential, subsection 547(c)(5) provides that the trustee may not avoid a transfer

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59. See notes 37-51 *supra* and accompanying text.

60. See note 51 *supra*.

61. 11 U.S.C. § 547(b) (Supp. IV 1980).

62. *Id.* § 547(c).

63. *Id.* § 547(c)(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—

- (A) (i) with respect to a transfer to which subsection (b)(4)(A) of this section applies, 90 days before the date of the filing of the petition; or
- (ii) with respect to a transfer to which subsection (b)(4)(B) of this section applies, one year before the date of the filing of the petition; and
- (B) the date on which new value was first given under the security agreement creating such security interest.<sup>64</sup>

This subsection reverses the broad sweep of section 547(b) by limiting the trustee's avoidance powers. Under this section the trustee may avoid security interests in receivables and inventory only to the extent that there has been, in the aggregate, a reduction of the amount by which the secured debt exceeded the value of the collateral between the date ninety days before the filing of the bankruptcy petition<sup>65</sup> and the date of the filing of the petition. In other words, if a debt secured by a floating lien on accounts receivable is undersecured<sup>66</sup> ninety days<sup>67</sup> before the filing of a bankruptcy petition, but is less undersecured or not undersecured at all on the date of bankruptcy, the bankruptcy trustee may avoid the security interests to the extent that they represent such an improvement in position of the secured creditor. This test has become widely known, not surprisingly, as the "improvement in position test."<sup>68</sup>

Application of the subsection 547(c)(5) improvement in position limitation to the Failing Industries example is necessary to determine whether, and to what extent, the bankruptcy trustee may avoid the security interest of First National Bank in the accounts receivable of Failing Industries. Assume that on July 5, the date of the filing of the bankruptcy petition, Failing Industries owed First National Bank \$80,000, secured by accounts receivable with a "value" of \$75,000. Assume further

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64. *Id.*

65. In the case of insiders with reasonable cause to believe the debtor was insolvent, this period is extended to one year. *Id.* § 547(c)(5)(A)(ii). In either case, however, the period begins no earlier than the first extension of secured credit. *Id.* § 547(c)(5)(B).

66. An undersecured debt is one which exceeds the value of the collateral, in this example, the accounts receivable.

67. Or, in the case of insiders, one year. See note 65 *supra*.

68. See, e.g., H.R. REP. NO. 595, 95th Cong. 2d Sess. 374, reprinted in [1978] U.S. CODE CONG. & AD. NEWS 6330; L. KING, *supra* note 32, at ¶ 547.41.

that on April 6, ninety days before the filing of the petition, Failing Industries owed First National Bank \$120,000, secured by accounts receivable with a "value" of \$100,000. Applying the voidability rules of sections 547(b) and (c), the bankruptcy trustee may avoid the transfer of security interests in receivables to First National Bank, but only to the extent that First National Bank improved its position in the ninety days before bankruptcy. Inasmuch as the indebtedness of Failing Industries exceeded the "value" of collateral on April 6 by \$20,000 while the indebtedness exceeded the "value" of the collateral on July 5 by only \$5,000, First National Bank has improved its position between those two dates by \$15,000. Therefore, the security interest of First National Bank in the accounts receivable of Failing Industries would be voidable to that extent. This result contrasts sharply with the probable disposition of the case under the 1898 Act, as interpreted in *DuBay* and *Grain Merchants*;<sup>69</sup> the former law would not have recognized a preference in this situation.

#### IV. THE DEFINITIONAL PROBLEM

The foregoing analysis ignores a significant problem. The determination as to whether a preference exists depends on a comparison of the difference between the "value" of the collateral and the amount of debt secured thereby at two points in time. The Code, along with state law incorporated therein, defines each concept leading to this crucial comparison with one major exception—the concept of "value." Nevertheless, the definition of "value" can determine the existence and magnitude of a preference, and can affect the allocation of the scarce resources of a bankrupt's estate between secured and unsecured creditors. Despite its significance, however, there is no single obvious definition which can satisfy the section 547 algorithm.

The Code contains no definition of the term "value" as used in section 547. Although the phrase "new value" is defined in section 547(a),<sup>70</sup> that definition concentrates on newness and uses "value" in the sense of consideration, rather than

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69. See notes 14-20 *supra* and accompanying text.

70. 11 U.S.C. § 547(a) (2) (Supp. IV 1980) provides:

"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.

*Id.*

as a measurable quantity. Since, under subsection 547(c)(5), "value" is a concept that must be measured, the section 547(a) definition is not useful. Similarly, the general definitional section of the Code<sup>71</sup> provides no help in defining "value."

In addition, analogies and references to other sections of the Code provide no significant guidance in determining the meaning of "value." Section 522<sup>72</sup> of the Code, which grants exemptions from the debtor's estate, uses "value" in the quantifiable sense in which it is used in subsection 547(c)(5). Although section 522 defines "value" as the "fair market value as of the date of the filing of the petition,"<sup>73</sup> the introductory language of that section stipulates that the definition applies only to that section, and thus is irrelevant to other sections of the Code.<sup>74</sup>

Section 506(a)<sup>75</sup> of the Code contains arguably relevant language, but is ultimately of little assistance. That section prevents secured creditors from having claims against a bankrupt's estate to the extent that such claims will be satisfied by collateral, and thereby allocates an undersecured claim between its secured and unsecured components.<sup>76</sup> The purpose of section 506, like that of its predecessor, section 57h of the 1898 Act,<sup>77</sup> is to allow "those having security . . . [to] get the benefit of that security, but . . . at the expense of reducing the claim upon which they are entitled to participate as a general creditor"<sup>78</sup>—that is, "to deduct the security from the debt."<sup>79</sup> To "deduct the security from the debt," the value of the security must be determined. Section 506(a) provides that "[s]uch

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71. *Id.* § 101.

72. *Id.* § 522.

73. *Id.* § 522(a)(2).

74. *Id.* § 522(a).

75. *Id.* § 506(a).

76. Section 506(a) provides in relevant part that:

An allowed claim of a creditor secured by a lien on property in which the estate has an interest, or that is subject to setoff under section 553 of this title, is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property, or to the extent of the amount subject to setoff, as the case may be, and is an unsecured claim to the extent that the value of such creditor's interest or the amount so subject to setoff is less than the amount of such allowed claim.

*Id.*

77. Bankruptcy Act of July 1, 1898, ch. 541, 30 Stat. 544, as amended by Act of June 22, 1938, Pub. L. No. 75-696, § 57h, 52 Stat. 840. See also 11 U.S.C. § 506(a), (b) (Supp. IV 1980).

78. *In re O'Gara Coal Co.*, 12 F.2d 426, 429 (7th Cir.), cert. denied, 271 U.S. 683 (1926).

79. *New York Trust Co. v. Palmer*, 101 F.2d 1, 3 (2d Cir. 1939).

value shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property, and in conjunction with any hearing on such disposition or use or on a plan affecting such creditor's interest."<sup>80</sup> The relevance of the section 506 definition of "value" for present purposes is debatable. The goal of that definition is not to define or determine the validity of a security interest. Rather, section 506 requires valuation of valid security interests in order to subtract their value from general unsecured claims against the estate. The section is totally irrelevant to subsidiary determinations of the "value" of some items of property at certain times for the purpose of analyzing the validity of asserted security interests under section 547.

Even if section 506 were relevant, its prescription for value would be of little assistance. The statement that "value shall be determined in light of the purpose of the valuation," standing apart from the remainder of the sentence, suggests only that the definition of value for section 547 analysis should be determined rationally. The remaining portions of the sentence merely add precautionary language suited not to section 547 but, rather, to distinctions between proceedings in Chapters 7 and 11<sup>81</sup> and subsequent hearings.<sup>82</sup>

The decision by Congress to leave "value" undefined for purposes of section 547 is perplexing. This is not an instance in which Congress has described broad parameters for the courts to apply to specific facts on a case-by-case basis. Nor does the English language supply the relevant meaning, since "value" can have several meanings, each of which would mandate different results. Rather, Congress inserted an extremely vague but fundamental term in an otherwise mathematically precise formula.

The legislative history of the Bankruptcy Reform Act<sup>83</sup> indicates that the lack of definition was not accidental. The 1970 report of the Gilmore Committee<sup>84</sup> suggested statutory language embodying an improvement in position test. Although this language<sup>85</sup> was quite different from the wording of section

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80. 11 U.S.C. § 506(a) (Supp. IV 1980).

81. *Id.* §§ 1101-1174.

82. See 3 L. KING, *supra* note 32, at ¶ 506.

83. See generally H.R. REP. NO. 595, S. REP. NO. 989, 95th Cong., 2d Sess., reprinted in [1978] U.S. CODE CONG. & AD. NEWS 5787-6573.

84. See note 27 *supra* and accompanying text.

85. The Committee's proposed section 60a(4)IV provided:

If inventory is acquired or receivables arise in the ordinary course of a debtor's business and become collateral covered by a security agree-



547 as ultimately enacted, the Committee also used the term "value" without defining it. In its commentary on the proposed revision, however, the Gilmore Committee stated:

The comparison of values at the two measuring points which the Draft requires poses problems of obvious difficulty. A statutory valuation formula would have been helpful. The Committee has considered a number of suggested formulas but has been unable to come up with a satisfactory one. The valuation problem is, therefore, left to the referees and judges.<sup>86</sup>

In the eight years between the issuance of the Gilmore Committee report and the enactment of the Code, the problem apparently was never again addressed, and no additional references to the definition of "value" appear in the legislative history.

## V. POSSIBLE DEFINITIONS OF "VALUE"

The search for a definition of "value" for use in section 547 is not a mere intellectual exercise seeking an elegant solution for a conceptual lacuna; it is a practical problem in the operation of a system which often holds the key to the allocation of hundreds of thousands of dollars of a debtor's assets. The determination of an appropriate definition requires identification of the various possible definitions, as well as criteria for evaluating the definitions in light of their likely effects and the goals of the bankruptcy system. Although it has been over a decade since the Gilmore Committee specifically highlighted the need for a definition of "value," neither Congress nor the commentators have given the matter any serious analysis.<sup>87</sup>

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ment, a perfected transfer of such inventory or receivables or the proceeds of either is not avoidable except to the extent that the transferee has improved his position under the rule next stated. The transferee has "improved his position" if (a) a deficiency existed on the date four months before the filing of the petition, or if new value was first given under the relevant security agreement during the four-month period, on the date new value was first given; and (b) that deficiency, on the date of filing the petition, has been reduced or converted into a surplus. 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. The transferee has the burden of establishing that he has not improved his position under the rules above stated. To the extent that a transfer is voidable under this subparagraph IV, it is voidable without regard to whether the debtor was insolvent at any date prior to the date of filing the petition or whether the transferee had reasonable cause to believe that the debtor was insolvent at the time of any transfer.

H.R. REP. NO. 595, 95th Cong., 2d Sess. 211, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS 6171.

86. *Id.* at 216, [1978] U.S. CODE CONG. & AD. NEWS at 6176.

87. Indeed, very few have even noticed the matter. A few commentators,

There are at least five possible definitions of the term "value":<sup>88</sup>

- *Face Value*. The value of each account receivable would be defined as the amount owed on the account by the account debtor.

- *Market Value*. The value of each account receivable would be defined as the amount for which the receivable could have been sold on the market at the relevant time.<sup>89</sup>

- *Collection Value*. The value of each account receivable would be defined as the money actually collected on the account by the account creditor or trustee in bankruptcy, possibly as adjusted for the time value of money.

- *Loan Value*. The value of each account receivable would be defined as the amount of money the lender actually loaned to the account creditor with such receivable as collateral.

- *Book Value*. The value of each account receivable would be defined as the net value as reflected in the books of the account creditor according to generally accepted accounting principles—presumably face value minus reserves for returned goods and uncollectable accounts.

A reexamination of the financing arrangement between the First National Bank and Failing Industries demonstrates that the choice of definition can be the critical factor in determining whether a preference exists and, if so, its magnitude. Suppose that First National Bank loaned Failing Industries eighty percent of the face amount of the latter's accounts receivable, secured by a security interest in all present and future accounts receivable. Assume further that Failing Industries filed a bankruptcy petition on July 5. In addition, assume that on April 6—ninety days earlier—the loan balance was \$120,000, secured by accounts receivable with a face amount of \$150,000, and that on July 5 the loan balance was \$80,000, secured by accounts receivable with a face amount of \$100,000; also, all receivables were "rolled over" during the ninety days prior to filing, so that none of the July 5 receivables existed on April 6. Assume also that

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relying on the principle stated in section 506, have suggested that "value" might be defined differently in liquidation cases than in reorganization cases, but have failed to suggest any usable definitions. See, e.g., 4 L. KING, *supra* note 32, at ¶ 547.41.

88. Obviously these approaches can be combined in various ways to result in a myriad of possible definitions.

89. This approach could be combined with Loan Value to yield a similar definition that values an account receivable as the amount a reasonable financier would loan with such receivable as collateral.

\$107,000 of the April 6 receivables and \$75,000 of the July 5 receivables were actually collected. Hypothesize in addition that a reasonable factor would have paid \$125,000 for the April 6 receivables but only \$50,000 for the July 5 receivables. Finally, assume that at all times Failing Industries carried on its books a reserve account for uncollectable receivables in the amount of twenty-five percent of the face amount of all outstanding receivables.

To determine whether any or all of the July 5 receivables constitute a preferential transfer to First National Bank that the bankruptcy trustee can avoid, one must apply the improvement in position test of section 547.<sup>90</sup> To apply that test, however, one must know the "value" of the receivables on both April 6 and July 5. The analysis will vary depending upon which definition of "value" is used.

If, for example, "value" is defined as face value, the preference analysis would be quite simple. On both April 6 and July 5, the face value of the accounts receivable exceeded the debt;<sup>91</sup> therefore, at neither point would the debt be deemed undersecured. Thus, no preference could be found.

On the other hand, the market value definition of "value" mandates a different method of analysis. On April 6, the "value" of the collateral was \$125,000, while its "value" on July 5 was \$50,000. Once again, no preference results, since First National Bank was not undersecured on April 6 and, therefore, could not have improved its position.

Application of a collection value definition to the case of Failing Industries, however, will result in the finding that a preferential transfer occurred. Under the collection value definition, the debt exceeded the "value" of the collateral on April 6 by \$13,000,<sup>92</sup> while the debt exceeded the "value" of the collateral on July 5 by only \$5,000.<sup>93</sup> The First National Bank improved its position by \$8,000 between April 6 and July 5, and section 547 would therefore indicate that the transfers to the bank of the security interests in the July 5 receivables are voidable to the extent of \$8,000.<sup>94</sup>

Defining "value" as loan value leads to a determination that

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90. See notes 65-68 *supra* and accompanying text.

91. On April 6, the face value of the receivables was \$150,000, while the loan balance was only \$100,000. On July 5, the face value of the receivables was \$100,000, while the loan balance was only \$80,000.

92. Debt of \$120,000 minus "value" of collateral of \$107,000.

93. Debt of \$80,000 minus "value" of collateral of \$75,000.

94. See 11 U.S.C. § 547(c)(5) (Supp. IV 1980).

no preference was created. On April 6, the value of both the debt and the collateral was \$120,000, while on July 5 the value of both the debt and the collateral was \$80,000. Under this definition, the bank did not improve its position and, accordingly, the transfers of security interests are not voidable.

Finally, if "value" means book value, a voidable preference will be found. Utilizing this approach, the receivables on both April 6 and July 5 had a value, according to the books of Failing Industries, of seventy-five percent of their face amount — \$112,500 for the April 6 receivables and \$75,000 for the July 5 receivables. Therefore, on April 6, the bank was undersecured by \$7,500—collateral with a value of \$112,500 securing a loan of \$120,000—while on July 5 it was undersecured by only \$5,000—collateral with a value of \$75,000 securing a debt of \$80,000. Pursuant to section 547, First National Bank received a preference to the extent of its \$2,500 improvement in position.

The case of Failing Industries demonstrates that the choice of the definition of "value" in subsection 547(c)(5) will determine the existence and magnitude of voidable preferences in a large number of receivables financing transactions. The choice of definition will have a significant impact on financiers, borrowers, general creditors, and bankruptcy trustees. A definition not only will conclusively determine the voidability of particular security interests in accounts receivable, but also will influence creditors' decisions as to the advisability of particular transactions.

## VI. CHOOSING THE APPROPRIATE DEFINITION

Interpretation of ambiguous statutes is always a difficult, uncertain undertaking. Interpretation of subsection 547(c)(5) is particularly difficult. Standard canons of statutory interpretation and construction<sup>95</sup> are of little avail when the statute to be interpreted is susceptible of many logical readings, and when the legislative history provides little guidance.<sup>96</sup>

Two of the posited definitions of "value," however, can be quickly eliminated from consideration. A cardinal rule of statutory interpretation, including interpretation of bankruptcy statutes, is that "the intent of the legislature is, and must be, the primary consideration."<sup>97</sup> Although Congress has not provided

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95. See generally, e.g., C. SANDS, *STATUTES AND STATUTORY CONSTRUCTION* (4th ed. 1973) (a revision of *Sutherland Statutory Construction*).

96. See notes 83-86 *supra* and accompanying text.

97. E. CRAWFORD, *THE CONSTRUCTION OF STATUTES* § 331 (1940).

any substantial indication of its intent in using the word "value," it has given ample guidance concerning one major result intended by the statutory scheme of which subsection 547(c)(5) is an integral part. As the House of Representatives report on section 547<sup>98</sup> makes clear, one major goal of section 547 was to overrule the doctrine of *Grain Merchants* and *DuBay*. The report states that subsection 547(c)(5)

codifies the improvement in position test, and thereby overrules such cases as *DuBay v. Williams* and *Grain Merchants of Indiana, Inc. v. Union Bank and Savings Co.* . . . A creditor with a security interest in a floating mass, such as inventory or accounts receivable is subject to preference attack to the extent that he improves his position during the 90-day period before bankruptcy.<sup>99</sup>

The report thus assumes that the improvement in position test of subsection 547(c)(5) will yield a result different from the application of the *DuBay—Grain Merchants* rule.

The loan value and face value definitions of "value," however, will in most cases lead to the same result—a finding of no preference—as would the rule in *DuBay* and *Grain Merchants*. In a typical accounts receivable financing arrangement, the financier loans the debtor only a portion of the face amount of the receivables; accordingly, the debt secured will always be less than the face amount of the receivables and, under the face value definition, less than the "value" of the collateral. Under the loan value definition, the "value" of the collateral is defined as equal to the debt secured thereby. Thus, under either definition, no loan will ever be undersecured. Because pursuant to subsection 547(c)(5), a voidable preference will result only if a secured creditor improves its position with regard to an undersecured loan, neither definition will ever lead to a voidable preference. Therefore, the face value<sup>100</sup> and loan value definitions fail to satisfy Congress's intent in adopting the improvement in position test and should be abandoned.

Book value should also be rejected as a definition of "value." Pursuant to generally accepted accounting principles, an account creditor usually carries accounts receivable on its books at a discount. The account creditor discounts debts to

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98. H.R. REP. NO. 595, 95th Cong. 2d Sess. 374, reprinted in [1978] U.S. CODE CONG. & AD. NEWS 6330.

99. *Id.*

100. Furthermore, the "face value" concept of value does not comport with economic reality. Since accounts receivable represent obligations of third parties to pay sums of money, the probability that such sums will be collected is less than one hundred percent. Therefore, the economic value of an account receivable is less than one hundred percent of its face amount.

book value in anticipation of its inability to collect some accounts, and the choice of an appropriate discount factor is within the account creditor's discretion. Inasmuch as one of the purposes of the voidable preference doctrine is to prevent manipulation by the debtor of the payment of creditors,<sup>101</sup> the choice of a definition of value which is wholly within the control of the account creditor seems inappropriate.

Choosing between the remaining possible definitions is more difficult. Both collection value and market value have some appeal, as well as significant limitations. These competing definitions result from two different perspectives.<sup>102</sup> The first perspective is result-oriented. It suggests that the voidable preference doctrine is designed to allow the bankruptcy trustee to avoid prebankruptcy transfers which would otherwise result in the transferee recovering a greater portion of its debt than other similar creditors. The second perspective is conduct-oriented. It suggests that the voidable preference doctrine is designed to deter or prevent creditors from accepting or demanding transfers from their debtors which will benefit such creditors at the expense of unsecured creditors.

The collection value approach is result-oriented, while the market value approach is conduct-oriented. Under the market value definition, a receivables creditor can determine at any particular time the "value" of collateral it has received. It can therefore calculate when, if ever, it is undersecured, and determine whether a particular transfer would improve its position. Such a creditor will lose collateral as a voidable preference only when it has chosen to conduct its business despite notice that receipt of collateral would be voidable if bankruptcy ensued.

The collection value approach is, on the other hand, retrospective. Since the determination of "value" is postponed until the receivables are collected, the trustee can determine with certainty whether a particular receivables creditor was actually in a better position on the day of bankruptcy than ninety days earlier. Thus, the trustee can avoid any transfer which results in an improvement in position without regard to whether this result could have been predicted.

To the extent that the market value of a particular set of receivables coincides with the money actually collected with

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101. See J. WHITE & R. SUMMERS, *supra* note 2, at 999.

102. See generally Jackson & Kronman, *supra* note 5, for an excellent analysis of voidable preference problems from different perspectives.

respect to them, the choice between these two definitions is irrelevant, since each will yield the same result. The choice of definition is critical, however, when the predictive market value diverges from the actual collection value. The typical accounts receivable financier lends its borrower only a portion of the face amount of the receivables which will secure the loan. The financier chooses an appropriate percentage to assure that in the event of default the collateral will be sufficient to repay the loan. The choice of percentage necessarily incorporates the sort of predictions regarding the money which will eventually be collected from the receivables that are inherent in their market value. Accordingly, the financier usually will not make a loan which exceeds the market value of the collateral.<sup>103</sup> Thus, even if the borrower files a bankruptcy petition ninety days after the loan, no voidable preference will be found under the market value definition, because the "value" of the collateral equals or exceeds the amount of the debt ninety days before bankruptcy. Furthermore, if the market's prediction of the collections as to the receivables proves accurate, no voidable preference can be found under the collection value definition for the same reason.

If the predictive market value of the receivables differs from the actual amount collected, the situation becomes more complicated. Although under the market value definition there still cannot be a preference, application of the collection value approach may yield a different result. If the market value of the receivables serving as collateral ninety days before bankruptcy was too conservative, and the actual amount collected exceeds that prediction, the collection value definition will not result in a preference since a higher determination of the "value" of the collateral merely renders the creditor even more oversecured. If, however, the market value was too optimistic, a preference is possible. If the amount collected, although less than predicted by the market, is nonetheless greater than the debt secured by the accounts, there is no preference because the debt was still oversecured ninety days before the filing of the bankruptcy petition. If, however, the amount collected is less than the debt, there is a possibility of a preference under the collection value definition because the creditor was undersecured ninety days before the petition was filed. If, on the date the petition was filed, either the collection value exceeds

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103. For a discussion of situations in which a financier might loan more than market value, see note 104 *infra*.

the secured debt or the debt exceeds the collection value by a smaller amount than it did ninety days earlier, a preference will be found to the extent of this improvement in position. In this situation, application of the market value definition will lead to a determination of no voidable preference, while application of the collection value approach will allow the trustee to avoid the financier's security interest in some of the receivables.

Situations in which application of the market value definition will lead to a voidable preference, while application of the collection value approach will not, are less likely to occur in the course of normal accounts receivable financing. To create a market value preference, the loan must exceed the market value of the receivables ninety days before bankruptcy. Since a professional financier is likely to be aware of the market value of the receivables, a decision to make such a loan is a decision to place itself in an undersecured position.<sup>104</sup> A preference arises if, by the addition of new receivables, the difference between the aggregate market value of the borrower's receivables and the loan at the date of filing in bankruptcy is less than the amount by which the loan exceeded the market value of the collateral ninety days earlier. If market value accurately predicts collections from the receivables, this scenario will also be a preference under the collection value definition. If, however, the market value of the receivables ninety days before bankruptcy was unduly pessimistic, and the sum actually collected equals or exceeds the loan outstanding on that date, there will be no preference under the collection value approach because the loan will not have been undersecured on the earlier date. Even if the market value and the collection value of the receivables existing ninety days before bankruptcy are equal, there may not be a preference under the collection value definition. A preference will only arise if the creditor's recovery on the receivables in existence on the date of the bankruptcy results in its being less undersecured than it was ninety days earlier.

In sum, if the market value of a group of receivables is an accurate predictor of their collection value, the two definitions

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104. The decision to loan more than the market value of the receivables may result from a number of factors. The financier may assign a higher value to the receivables than does the market. Alternatively, the financier may be willing to accept greater risks than the market. In addition, the borrower's business cycle may be seasonal and the financier is willing to be undersecured at the time of the initial loan, with the expectation that large accounts receivable will come into existence later in the cycle.



will yield common results. The collection value definition, but not the market value definition, will mandate a preference if the receivables in existence ninety days before bankruptcy yield significantly less than predicted. Conversely, the market value definition, but not the collection value definition, will mandate a preference if the creditor, based on market-oriented predictions, would have believed itself undersecured ninety days before bankruptcy and the receivables yield more than predicted.

Both the market value and collection value definitions, moreover, emphasize a different policy goal associated with the voidable preference doctrine. Insofar as the two definitions diverge, the choice of one over the other should, if possible, reflect Congress's view of the aims of the voidable preference doctrine. A choice of the collection value definition would reflect a result-oriented goal, while a choice of the market value definition reflects a conduct-oriented goal. Although the legislative history of the Code reveals no intention regarding the definition of "value,"<sup>105</sup> it does provide some indication of the policies underlying the federal doctrine of voidable preferences. The House Judiciary Committee, in its report on the Bankruptcy Reform Act,<sup>106</sup> found that under the 1898 Act the purposes of the voidable preference doctrine were two-fold:

First, by permitting the trustee to avoid prebankruptcy transfers that occur within a short period before bankruptcy, creditors are discouraged from racing to the courthouse to dismember the debtor during his slide into bankruptcy . . . . Second, and more important, the preference provisions [of the 1898 Act] facilitate the prime bankruptcy policy of equality of distribution among creditors of the debtor. Any creditor that received a greater payment than others of his class is required to disgorge so that all may share equally.<sup>107</sup>

The first of the two purposes—deterrence—was, of course, "operative only if the creditor was aware of the risk of loss."<sup>108</sup> Thus, it was conduct-oriented. The second purpose—equality—had no conduct-oriented dimension; it was result-oriented.

The conduct-oriented purpose of the 1898 Act was embodied in section 60b,<sup>109</sup> which provided that a trustee could avoid a preferential transfer only if the creditor, at the time of trans-

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105. See notes 83-86 *supra* and accompanying text.

106. H.R. REP. NO. 595, 95th Cong., 2d Sess. 374, reprinted in [1978] U.S. CODE CONG. & AD. NEWS 6330.

107. *Id.* at 177-78, [1978] U.S. CODE CONG. & AD. NEWS at 6137-39.

108. Nimmer, *Security Interests in Bankruptcy: An Overview of Section 547 of the Code*, 17 HOUS. L. REV. 289, 291 (1980).

109. Act of July 1, 1898, ch. 541, 30 Stat. 544, as amended by Act of June 22, 1938, Pub. L. No. 75-696, § 60b, 52 Stat. 840.

fer, had "reasonable cause to believe the debtor [was] insolvent."<sup>110</sup> Thus, the 1898 Act required an element of intentional conduct or acquiescence by the transferee in order to create a voidable preference. Section 547, however, has eliminated the requirement of notice of insolvency as a prerequisite to voidability. The Judiciary Committee, commenting on this deletion, observed:

This provision [§ 60b] was designed when the primary purpose of the preference section was to prevent the race of diligence. Whether or not a creditor knows or believes that his debtor is sliding into bankruptcy is important if the only purpose of the preference section is to deter the race. However, a creditor's state of mind has nothing whatsoever to do with the policy of equality of distribution, and whether or not he knows of the debtor's insolvency does little to comfort other creditors similarly situated who will receive that much less from the debtor's estate as a result of the prebankruptcy transfer to the preferred creditor. To argue that the creditor's state of mind is an important element of a preference and that creditors should not be required to disgorge what they took in supposed innocence is to ignore the strong bankruptcy policy of equality among creditors.<sup>111</sup>

Although this statement does not address the meaning of "value" in subsection 547(c)(5), it does suggest legislative approval of a result-oriented preference policy. Because the collection value definition shares this result-oriented perspective, collection value would appear to match most closely the intent of Congress.

The choice of a collection value definition, however, would add an element of risk to the financier's calculus of decision-making concerning the loan. The risk that a loan which never appears to be undersecured may, nonetheless, be found to be secured by preferential transfers is likely to cause financiers to change their lending practices. They may raise their interest rates for accounts receivable financing to reflect the increased probability of loss. In addition, they may lend borrowers a smaller percentage of the face amount of their accounts receivable to minimize the likelihood of being undersecured. Finally, they may refuse to make loans which otherwise would have been made to financially uncertain enterprises. Each of these responses has a potentially serious impact on businesses that rely on accounts receivable financing.

There is an alternative, however, to the exclusive use of the collection value definition. That alternative is to tailor the definition to the situation. The ultimate goal of the subsection

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110. *Id.*

111. H.R. REP. NO. 595, 95th Cong., 2d Sess. 178, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS 6138-39.

547(c) (5) improvement in position test is to determine whether the secured creditor is in a better position than it would have been had bankruptcy been declared ninety days earlier. An individualized definition that answers that question for each particular creditor, rather than a general definition, may result in a more accurate appraisal of the creditor's improvement in position.

An individualized approach need be neither difficult to apply nor arbitrary. In each bankruptcy proceeding, the creditor or the trustee at some point liquidates the accounts receivable constituting collateral. This can be done either by collecting the accounts or by selling them. To determine whether the creditor is in a better position than it would have been had bankruptcy been declared ninety days earlier, the appropriate comparison would seem to be between the proceeds of the receivables actually liquidated after bankruptcy and the amount which would have been obtained if the receivables serving as collateral ninety days earlier had been liquidated in the same manner. In other words, if the receivables at bankruptcy were liquidated by collection, the comparison should be with the amounts actually collected from receivables serving as collateral ninety days before bankruptcy.<sup>112</sup> If the receivables were liquidated by sale, the comparison should be with the amount which would have been received had the receivables serving as collateral ninety days before bankruptcy been sold.<sup>113</sup> Thus, the first example adopts a collection value approach, while the second uses a market value approach. Because this individualized approach defines "value" in accordance with the method actually chosen to transform the accounts receivable to cash, it more accurately measures how much a particular creditor actually improved its eventual position during the ninety days before bankruptcy.

## VII. CONCLUSION

The failure of Congress to define "value" in subsection

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112. Bankruptcy proceedings, however, may discourage some account debtors from paying the amounts they owe. Accurate determination of the financier's improvement in position might therefore require a reduction of the amount actually collected from the earlier receivables to reflect the receivables which would not have been collected had bankruptcy occurred at the earlier date.

113. For an accurate comparison, the determination should be made assuming that bankruptcy proceedings were commenced prior to the sale of the receivables.

547(c)(5) of the Code will result in serious problems for businesses dependent on accounts receivable financing. The uncertainty as to the definition and, therefore, the validity of security interests in accounts receivable may lessen the availability or raise the cost of this financing for businesses which need it most. Furthermore, the definition of value which is most consistent with the sparse indications of legislative intent—collection value—itself adds some uncertainty to the process and, thus, would further decrease the availability or raise the cost of accounts receivable financing. Resolution of the definitional problem through the use of definitions tailored to the facts of particular cases may result in treatment by the courts in a manner more consistent with the underlying purposes of the voidable preference doctrine than would result from application of one consistent definition to all cases.

