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Tripartite Voidable Preferences

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Claims & Opinions

TRIPARTITE VOIDABLE PREFERENCES

By
David Gray Carlson*

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As Caesar knew, the tripartite cases are always the most difficult, but this does not mean they cannot be subdued, given sufficient patience, insight, and brute force. So it is in voidable preference law.

A transfer of an interest in debtor’s property shortly before bankruptcy may be a voidable preference. The theory behind voidable preferences is that unsecured creditors are supposed to be treated equally with other creditors of similar rank. If a transfer from the debtor produces more for the creditor than the bankruptcy distribution would have, then the creditor may be forced to return the property to the bankruptcy estate so that it can be divided ratably among the creditors.

A voidable preference case is tripartite when a transfer to one creditor benefits another creditor. Section 547(b) of the Bankruptcy Code condemns transfers of a debtor’s property “to” a creditor and, in addition,

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transfers "for the benefit of a creditor." One transfer, then, may result in multiple liabilities. Either the transferee or the party who benefited from the transfer may be forced to return the property or its value to the bankruptcy estate.

Tripartite cases are especially complicated by the fact that the period during which preferences are voidable is ninety days for ordinary creditors while it is one year for "insiders." Thus a creditor initially receiving the transfer might be subject to the ninety day period, while the creditor who benefited by the same transfer might be an insider subject to a one year period.

Quite independently from section 547(b), tripartition arises from section 550(a), the general liability provision for trustee avoidance powers. According to section 550(a):

\[
to the extent that a transfer is avoided under section \ldots 547 \ldots the trustee may recover, for the benefit of the estate, the property transferred, or, if the court so orders, the value of such property, from— (1) the initial transferee of such transfer or the entity for whose benefit such transfer was made \ldots .
\]

To be sure, section 550(d) limits the trustee "to only a single satisfaction under subsection (a) of this section." Hence, although the trustee may ultimately recover once, tripartition increases the number of parties from whom the trustee might ultimately recover.

Louring over any discussion of tripartite voidable preferences is the landmark case of \textit{Levit v. Ingersoll Rand Financial Corp.} Universally referred to as the \textit{Deprizio} case, in honor of the debtor, V.N. Deprizio Construction Co., the opinion used section 550(a)(1) to extend the voidable preference period against the transferee from ninety days to one year whenever a lender obtained an insider guaranty. That is, the insider surety received a benefit from a transfer to the assured creditor within the

\footnotesize
\begin{itemize}
  \item \textit{Id.} § 547(b)(1).
  \item \textit{Id.} 11 U.S.C. § 550(a) (1988). Unless otherwise indicated, all references in this Article are to sections of the Bankruptcy Code.
  \item \textit{Id.} (emphasis added).
  \item \textit{Id.} § 550(d).
  \item \textit{874 F.2d 1186} (7th Cir. 1989). \textit{See infra} Section III.
\end{itemize}
one year period, and the assured creditor, as initial transferee, had to pay for it, even though the transfer was more than ninety days old by the time of the bankruptcy petition. Section 550(a)(1) did not excuse an initial transferee just because the transfer was more than ninety days old.

This result scandalized the financial community, which saw no reason why a creditor who prudently obtains suretyship rights against an insider should be penalized with a longer preference period. Accordingly, Congress amended section 550(a)(1) to assure that only insiders are vulnerable for transfers made more than ninety days before bankruptcy. This amendment re-letters all the subsections of section 550 and adds subsection (c), which reads:

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.8

This amendment ends or at least severely limits the reign of Deprizio, which continued to gain adherents amongst appellate courts until the very eve of the amendment.9

Nevertheless, tripartite voidable preference cases present a great deal of complexity in their own right, even if Deprizio is all but dead. Accordingly, Part I of the Article will focus on matters arising solely from the text of section 547(b). This provision sets forth the prima facie case which a trustee must establish in order to recover a voidable preference. Part II will consider defenses to the prima facie case that arise under section 547(c). Deprizio itself — and the new environment created by the repeal of Deprizio — will be the subject of Part III of the Article.10

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9 The Eleventh Circuit endorsed Deprizio in the summer of 1994, just as Congress was about to reverse it. Galloway v. First Alabama Bank (In re Wesley Indus., Inc.), 30 F.3d 1438 (11th Cir. 1994).

10 This Article is one of a series that addresses the law of security interests on personal property and their fate in federal bankruptcy proceedings. Accordingly, I focus here on issues of concern to secured creditors only. Nevertheless, virtually everything that will be said is of relevance to unsecured creditors who have received the benefit of a transfer to some other creditor.
I. THE TRUSTEE'S PRIMA FACIE CASE

A. Benefit

Quickly, a voidable preference is a transfer of property just before bankruptcy. The transfer is voidable because it tends to violate the norm that unsecured creditors ought to be equal in the bankruptcy.\(^{11}\) Section 547(b) does not strictly require that a creditor receive a transfer of debtor property in order to be liable for its return. Section 547(b)(1) is equally offended if a transfer is merely “for the benefit” of a creditor. Section 550(a)(1) reiterates the point, rendering liable either “the initial transferee” of a voidable preference or “the entity for whose benefit such transfer was made . . . .”\(^{12}\)

\(^{11}\) For a complete analysis of the basic elements of voidable preferences in simpler bipartite cases, see David Gray Carlson, Security Interests as Voidable Preferences Under the Bankruptcy Code, 1995 ILL. L. REV. — (forthcoming). Section 547(b) sets forth six familiar elements of the trustee’s cause of action. They are: (1) The debtor has transferred an interest in its own property. This requirement appears in the preamble of section 547(b); (2) The property was transferred “to or for the benefit of a creditor;” (3) The transfer was “for or on account of antecedent debt owed by the debtor before such transfer was made . . . ;” (4) The transfer was made at a time when the debtor was insolvent. 11 U.S.C. § 547(b)(1)-(3) (1988). For purposes of § 547, the debtor is presumed to be insolvent on and during the 90 days immediately preceding the bankruptcy. Id. § 547(f). Under Fed. R. Evid. 301, “a presumption imposes on the party against whom it is directed the burden of going forward with evidence to rebut or meet the presumption, but does not shift to such party the burden of proof in the sense of the risk of nonpersuasion, which remains throughout the trial upon the party on whom it was originally cast.” (5) The transfer was made on or within 90 days of bankruptcy, id. § 547(b)(4)(A), or within one year of bankruptcy, in the case of insiders. 11 U.S.C. § 547(b)(4)(B). Insiders are defined in § 101 (31). (6) The transfer 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 . . . .

Id. § 547(b)(5). This last element is the hypothetical liquidation test, which establishes that a transferee may not receive more than he would have had there been a chapter 7 liquidation. Otherwise, it would violate the prime bankruptcy policy of equality of distribution among similarly situated creditors.

Some courts think there are more than six elements. See, e.g., Lingley v. Stuart Shaines, Inc. (In re Acme-Dunham Inc.), 50 B.R. 734, 737 (D. Me. 1985) (“In addition to the express statutory requirements of a preference, many courts . . . have held that for a transfer to be preferential in the forbidden sense, it must ‘diminish the fund to which creditors of the same class can legally resort for the payment of their debts.’”) (quoting Kapela v. Newman, 649 F.2d 887, 892 (1st Cir. 1981) (citing COLLIER ON BANKRUPTCY § 60.20, at 859-60 (14th ed. 1977))). See also Coral Petroleum, Inc. v. Banque Paribas-London, 797 F.2d 1351, 1355-56 (5th Cir.), reh’g denied, 801 F.2d 398 (5th Cir. 1986). For an attack on this “diminution” requirement, see Thomas M. Ward & Jay A. Shulman, In Defense of the Bankruptcy Code’s Radical Integration of the Preference Rules Affecting Commercial Financing, 61 WASH. U.L.Q. 1, 40-41 (1983).

“Benefit” is a vague word, and it has caused great detriment to jurisprudence wherever it has reared its ugly head. For our purposes, it can be said that “benefit” invokes a welfare analysis—a comparison of the creditor’s well-being before the transfer and her well-being after it. Thus, a court must make the following implicit calculation in a tripartite voidable preference case: Just prior to the challenged transfer, a creditor assesses her wealth and happiness as equal to some quantity. Call this quantity \( A \). After some other person receives a transfer, our creditor reassesses her total utility at \( A^1 \). If \( A^1 > A \) and the transfer “caused” this increase in happiness, then the creditor has enjoyed a “benefit,” which section 547(b)(1) is keen to stamp out.

Notice that even the slightest benefit rains guilt upon a creditor, but, once guilt is established, the creditor is not merely liable for the value of the benefit, but is liable for the value of the entire transfer. Thus, even where the benefit is very small and the transfer is very large, the benefited creditor is liable for the latter, larger amount.

1. Sureties

Suretyship is the archetypical (but not the only) case in which transfers to one creditor might benefit another. Typically, payments to assured creditors benefit the surety because, to the extent that the debtor pays the assured creditor, the surety is relieved of liability. Since, by definition, the debtor is insolvent in the context of voidable preferences, any dollar the assured creditor extracts from the debtor will displace a subrogation claim worth less than a dollar. Because this displacement benefits the surety, the surety may be liable for the value of transfers made to the assured creditor.

\[ \text{Naturally, for a preference to be voidable, all the other elements of § 547(b) must be met, and the transaction cannot qualify for any defenses under § 547(c). The present discussion concerns only the element of “benefit” in § 547(b)(1).} \]

\[ \text{But see T.B. Westex Foods, Inc. v. Federal Deposit Ins. Corp. (In re T.B. Westex Foods, Inc.), 950 F.2d 1187, 1195 (5th Cir. 1992) (“Section 547(b)(5) provides that the transfer is avoidable only to the extent that the benefit that the insider received from the transfer exceeded the amount that the insider would have received under a Chapter 7 distribution.”); see also Levit v. Ingersoll Rand Fin. Corp., 874 F.2d 1186, 1195 (7th Cir. 1989) (wrongfully assuming that the trustee can only recover the value of the “benefit”).} \]

\[ \text{For example, transfers to a senior secured party might benefit a junior secured party. See infra notes 64-68 and accompanying text.} \]

\[ \text{11 U.S.C. § 547(b)(3) (1988).} \]

\[ \text{This will be true unless the surety or the assured creditor is oversecured. On the effect of oversecurity, see infra notes 140-41 and accompanying text.} \]

\[ \text{In Trollopean contexts, this can be cruel, as in Gosch v. Burns (In re Finn), 111 B.R. 123} \]
Not all payments to the assured creditor will benefit a surety. For example, if the surety has guaranteed all the creditors, then payment of one creditor instead of another does not "benefit" the surety.\textsuperscript{19} This is good news for general partners who are generally liable for partnership debts.\textsuperscript{20} Because general partners are insiders of a bankrupt partnership, they are subject to the one year preference period, rather than the ninety day period for ordinary creditors. Payments to the ordinary creditors cannot benefit the general partners unless the partnership has issued nonrecourse debt to other creditors. If nonrecourse debt exists, then favorable treatment of a recourse creditor over a nonrecourse creditor can indeed radiate a benefit fatal to general partners.\textsuperscript{21}

It is very possible to argue that insolvent sureties enjoy no benefit when the assured creditor receives a transfer. The transfer implies that the insolvent surety will have one less creditor chasing the surety's inadequate assets, but if the surety is drowning in a sea of debt, it is certainly possible to say that removing one cup of water from the surety's ocean of despair will not make her any the less a toast for Neptune.

Yet, in the sore agony of her death, the insolvent surety, in good conscience, should maximize her estate for the benefit of the creditors before she sinks below the tumbling billows of the main. If a court in-


\textsuperscript{20} And under Deprizio, it was good news for creditors of general partners, who are liable as initial transferees under Bankruptcy Code § 550(a)(1) as the initial transferees of others' voidable preferences. For cases acquitting creditors with claims against partnerships, see Broad Street Assoc. v. United Cos. Life Ins. Co. (In re Broad Street Assoc.), 163 B.R. 68, 72-73 (Bankr. E.D. Va. 1993); Unsecured Creditors' Comm. of Seasons Properties v. Miller & Martin (In re Seasons Properties), 141 B.R. 631, 634 (Bankr. E.D. Tenn. 1992). For a case denying that removal of creditors generally facilitated the possibility that the partnership debtor might have an equity account in the future that would "benefit" the general partner, see Marshack v. Wells Fargo Bank (In re Walters), 163 B.R. 575 (Bankr. C.D. Cal. 1994).

\textsuperscript{21} For example, suppose a partnership debtor has $100 in assets. It owes $100 to A and $100 to B. B has waived recourse against the general partners of the debtor. If the debtor pays $100 to A, the general partners benefit because they are relieved of $100 of liability, since B has no recourse. If both creditors are recourse creditors, payment of A (in lieu of a pro rata division) is a matter of no consequence to the general partners because they still owe B $100.

Conversely, if the debtor were to pay B, the general partners would be harmed, because A loses a pro rata share of the debtor's estate and therefore will recover her full $100 from the general partners.
dulges in the fiction that all insolvent sureties would do what fiduciary duty and good character demand, then anything that tends to eliminate a potential creditor benefits the estate of the surety, even as the surety herself is drowned. Thus, when we presume the surety is a fiduciary to her surfeit of creditors, the surety benefits when the assured creditor is paid.

In *Official Unsecured Creditors’ Committee v. United States National Bank of Oregon (In re Suffola, Inc.)*, Judge Jerome Farris ruled that insolvent sureties always benefit when the assured creditor receives transfers from the debtor. “Insolvency is transitory,” he cheerfully observed, “or at least not inherently permanent. A decrease in the degree of insolvency, like an increase in the degree of solvency, is beneficial.” Hence, just as death is merely prologue to resurrection, so insolvency might be overcome by some analogous miracle.

2. Nonrecourse Sureties

What constitutes a “benefit” to nonrecourse sureties has proved controversial. Payments to an assured creditor benefit sureties to the extent that the assured obligation shrinks, but this shrinkage might not occur if the assured creditor is undersecured, and the surety has pledged collateral on a nonrecourse basis. This occurred in *Travelers Insurance Co. v. Cambridge Meridian Group, Inc. (In re Erin Food Services, Inc.)*. The surety had pledged about $19 million in collateral on a nonrecourse basis, but the assured creditors had $61 million in claims against this property. The assured creditors received under $3 million in payment from the debtor just before bankruptcy.

Judge Cyr ruled that the surety received no benefit until the assured obligation fell below $19 million in amount. Only thereafter would collateral be disencumbered. For this reason, the payments did not “benefit”

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22 2 F.3d 977 (9th Cir. 1993).

23 *Id.* at 986; accord *Clark v. Balcor Real Estate Fin., Inc. (In re Meredith Hoffman Partners)*, 12 F.3d 1549, 1555-56 (10th Cir. 1993). *See also Lowrey v. Manufacturer’s Hanover Leasing Corp. (In re Robinson Bros. Drilling, Inc.),* 6 F.3d 701 (10th Cir. 1993) (where insider was $96 million in debt, payment of $176,000 to assured creditor still constituted a benefit to the insider surety).

24 *See also T.B. Westex Foods, Inc. v. Federal Deposit Ins. Corp. (In re T.B. Westex Foods, Inc.),* 950 F.2d 1187, 1192 n.8 (5th Cir. 1992) (fact that alleged surety actually went bankrupt and had all debts discharged did not mean that earlier transfers prior to discharge were not for the alleged surety’s benefit).

25 980 F.2d 792 (1st Cir. 1992).

26 “If Erin had not made the three interest payments, [the surety] would have held a contingent unsecured claim against the debtor estate in the amount of $19.35 million; immediately after the challenged transfers, [the surety] held a contingent unsecured claim in the same amount.” *Id.* at 803.
the surety, and hence the surety was not liable for a voidable preference.27

Ironically, had the surety filed a chapter 11 petition—as commonly happens when the surety is an insider—the nonrecourse claim of the assured creditor would have become a recourse claim. According to section 1111(b)(1)(A), a nonrecourse creditor must be treated as having recourse, unless the debtor plans to sell the collateral. This creation of artificial recourse, however, exists only in chapter 11 and nowhere else. Given this artificial recourse, the surety’s chapter 11 petition would have generated a voidable preference liability in the bankruptcy of the principal obligor.

Because an insolvent surety has the power to file for bankruptcy in chapter 11, where the nonrecourse claim becomes a recourse claim, the mere potential of recourse in chapter 11 could prove that the insolvent nonrecourse insider has benefited when the undersecured assured creditor receives a transfer on the underwater part of the claim. But not every insolvent party belongs in chapter 11. Chapter 11 is premised on producing a dividend for a creditor that equals or exceeds a hypothetical chapter 7 dividend.28 This Paretian requirement of net going concern value will eliminate chapter 11 as an honest possibility for many debtors. With it goes any voidable preference theory in the principal obligor’s bankruptcy, where the surety must be viewed as nonrecourse.29

27 In a similar case, Judge Philip G. Reinhard wrote:

[T]he plain language of section 547(b) refers to benefit. There is nothing in the language of section 547(b) to suggest that benefit is equivalent to potential or possible benefit. Second, it cannot necessarily be said that with each payment the guarantors were brought one step closer to the direct reduction of their guarantee. Each payment may very well have brought [the debtor] closer to bankruptcy and thus increased the likelihood that the guarantors would become liable to Sequa. Suffice it to say, the concepts of potentiality and possibility carry with them all sorts of unknown or unpredictable consequences which do not readily lend themselves to an ascertainable determination of the existence of a benefit. Consequently, this court does not consider the term “benefit in section 547(b) to embrace potential benefit.

Cannon Ball Indus., Inc. v. Sequa Corp. (In re Cannon Ball Indus., Inc.), 155 B.R. 177, 180 (Bankr. N.D. Ill. 1993).


29 The sequence of the bankruptcy petitions may be relevant here. If the original debtor filed first, the surety’s contingent claim against the debtor is limited to the value of the surety’s collateral pledged to the assured creditor. The later addition of a recourse liability is a postpetition event, insofar as the principal obligor is concerned. It is often held that, in hypothesizing a liquidation for the purpose of the test in § 547(b), a court may not imagine any postpetition event. Neuger v. United States (In re Tenna Corp.), 801 F.2d 819 (6th Cir. 1986); Carlson, supra note 11. On the other hand, if the surety filed first, then recourse exists as of the time of the original debtor’s bankruptcy. Palmer Clay Prods. v. Brown, 297 U.S. 227, 229 (1936) (hypothetical liquidation test judged on facts that exist as of the bankruptcy petition). When the assured creditors were paid, however, the surety was nonrecourse. At this time, “benefit” would have to be based on the mere potential to file for
Erin Food Services bears a contradictory relationship with Official Unsecured Creditors’ Committee v. United States National Bank of Oregon (In re Suffola, Inc.), where Judge Jerome Farris held that any transfer to the assured creditor benefits the insolvent surety, because insolvency is only transitory. In both cases, the transfers in question did not cause direct harm to the surety’s equity interest in its own estate, but each represented an incremental step toward that future possibility. Yet Erin Food Services held that benefit did not exist, whereas Suffola held the opposite.

3. Assured Creditors

Transfers to the assured creditor may benefit the surety, but what about the converse? Can the surety’s security interest benefit the assured creditor? If so, the assured creditor assumes potential liability for the beneficial transfer.

Sometimes, transfers clearly increase the welfare of the assured creditor. For example, suppose the debtor appeases an unpaid creditor with a new surety arrangement. As inducement for the extension of this new credit, the debtor grants the surety a security interest. Being the sine qua non of the suretyship arrangement, the security interest clearly benefits the assured creditor on an antecedent debt. In such cases, the assured creditor is liable for the value of the security interest granted to the surety.

A surety’s security interest benefits the assured creditor when the surety receives it contemporaneously with the surety’s extension of credit. But where the suretyship comes first with the security interest following thereafter, it is far from clear whether the assured creditor is benefited. For example, suppose an assured creditor obtains the guaranty of some solvent insider. The insider has no collateral from the debtor. Later, just before the debtor’s bankruptcy, the insider nervously takes collateral from the debtor for any subrogation claim. In this example, the assured creditor has not benefited from the grant of this security interest. The unsecured guaranty was enough to guarantee repayment; the subsequent security in-

chapter 11 bankruptcy.

2 F.3d 977 (9th Cir. 1993).

This case is discussed supra in the text accompanying notes 22-24.

Interest granted to the surety adds nothing to the rights of the assured creditor and is merely for the benefit of the surety who received it directly. Similarly, if the assured creditor possesses an adequate security interest on assets of the surety or the surety has already paid up on her obligation to the assured creditor, any subsequently created security interest enriches only the surety, not the assured creditor.

If, however, the surety was insolvent at the time it received the security interest from the debtor on antecedent debt, and if the assured creditor has no security interest from the surety, it is possible to spy some benefit to the assured creditor. The argument, admittedly difficult, may proceed as follows: Any payment by the insolvent surety to the assured creditor would be a voidable preference in the surety's own bankruptcy. Nevertheless, if the surety pays, knowing that the payment can be recovered entirely from collateral pledged by the principal obligor (the debtor), the insolvent surety, as fiduciary for her general creditors, has furthered the interests of her creditors. The elimination of one unsecured creditor at the expense of a third party benefits all the unsecured creditors of the insolvent surety who remain. This incentive to pay the assured creditor, arising from the insolvent surety's security interest, constitutes the benefit to the assured creditor, rendering the assured creditor liable to the principal obligor's trustee for the surety's security interest.

Yet the payment by the insolvent surety to the assured creditor is at least potentially voidable in the surety's bankruptcy. The voidability of this payment complicates the claim that any security interest transferred to the insolvent surety (after the suretyship agreement is executed) benefits the assured creditor. A paradox exists that may prevent an assured creditor from ever obtaining the benefit of a security interest issued directly to an insolvent surety.

One idea from state law could radically strengthen the position of the principal obligor's bankruptcy trustee. The Restatement of Suretyship, like its ancestor, the Restatement of Security, declares that the assured creditor is always subrogated to the security interests granted to the surety. If followed, then security interests issued to the surety always

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39 RESTATEMENT OF SECURITY § 140 (1941).
40 According to § 29 of Restatement of Suretyship:
When the principal obligor supplies collateral securing its duty of performance or reimbursement to the secondary obligor, and the secondary obligor defaults on the secondary obligation, the obligee may elect to enforce for its benefit the rights of the secondary obligor

benefit the assured creditor and therefore the assured creditor is always liable for them when all other elements of section 547(b) are satisfied. This is an ironic result, since the Restatement of Suretyship aims to help, not harm, the assured creditor.

Assume that a security interest issued to a surety on antecedent debt actually does benefit the assured creditor. In principle, section 550(a)(1) authorizes the trustee to recover the "property transferred"—specifically, the security interest granted to the insider—"if the court so orders." That is, the trustee may, with court permission, let the security interest stand and instead obtain the value of the security interest. Furthermore, the value of the security interest may be recovered either from the insider ("the initial transferee" of the preference) or the "person benefited" by the security interest. This means that the insider may keep the security interest in question, but the unpaid assured creditor will have to reimburse the bankruptcy trustee for the value of this security interest. That is, the assured creditor is out of pocket on the original loan and must pay for the security interest issued to the surety. Chapter 11 exacerbates this discrepancy when the insider is in control of the debtor-in-possession and hence primarily responsible for setting litigation strategy. The insider is therefore in a position to suggest that the recovery be aimed at the assured creditor and not at herself.

Taunt v. Fidelity Bank (In re Royal Golf Products Corp.)\textsuperscript{36} raised such an issue. There, the insider surety executed an irrevocable letter of credit to guarantee a loan taken by Royal Golf. When Royal Golf defaulted, the assured creditor was prepared to draw on the letter of credit. To avoid losing the shares of Royal Golf pledged as collateral for the line of credit, the insider paid the assured creditor out of his own assets. The insider, however, also had a prior security agreement with Royal Golf to collateralize any subrogation claim arising from a payment made on the corporation's behalf.

Both the bankruptcy and appellate courts found these payments to be voidable preferences to the extent they diminished the debtor's estate by increasing the insider's security interest.\textsuperscript{37} Thus, the insider's security interest was allowed to stand while the payment to the assured creditor was

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\textsuperscript{36} 908 F.2d 91 (6th Cir. 1990).

\textsuperscript{37} Id. at 95.
avoided. This astonishing result could follow only if the surety’s security interest, received antecedently to the suretyship agreement, benefited the assured creditor.

To be precise, the security interest in *Royal Golf Products* was created contemporaneously with the suretyship agreement and loan by the assured creditor, but the surety forgot to perfect his security interest. The Bankruptcy Code defers the timing of such transfers, so that what was previously an unpreferential contemporaneous exchange becomes a transfer on antecedent debt. This manipulation of timing illustrates one of the principal ways in which the Bankruptcy Code persecutes unperfected security interests.

If one focuses on the contemporaneous exchange, the security interest “benefited” the assured creditor because it may have been part of the financial package that induced the assured creditor to lend. If one focuses on the perfection of the security interest and the timing of the transfer, the security interest is on antecedent debt, and its beneficial effect on the assured creditor is less clear.

In any case, by holding the assured creditor liable, Judge Jones in *Royal Golf Products* implied that the security interest benefited the assured creditor. The assured creditor in that case suggested that, given the invalidity of the surety’s unperfected security interest in bankruptcy, the surety should be treated as an unsecured surety, and the assured creditor should therefore be excused from all liability for the security interest. In other words, the assured creditor argued that it obtained no benefit from a security interest that was unperfected, because an unperfected security interest is tantamount to no security interest.

The assured creditor’s argument overlooks the fact that the unperfected security interest is a transfer from the debtor to the surety just before bankruptcy, under the timing rule of section 547(e)(2)(C). It is precisely this unperfected security interest that the trustee was seeking to avoid, and the assured creditor, as the “beneficiary” of the security interest, was liable for its value, under section 547(b)(2) and section 550(a)(1). When the dust settled, the surety would be a secured, not unsecured, creditor in the debtor’s bankruptcy, because, having recovered

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38 Id.
40 See Carlson, supra note 11.
42 Id. § 547(b)(2).
43 Id. § 550(a)(1).
once from the assured creditor, the trustee could not recover again from
the insider. 4

4. Nexus

In all of the above suretyship situations, the trustee's recovery was
predicated upon benefit to a creditor of the debtor. Either the surety bene-
fited with regard to her contingent claim against the debtor, or, con-
versely, the assured creditor benefited by transfers to the surety. In both
cases there was a connection (or nexus) between the suretyship contract
and the benefit received. Many courts assert this nexus as a vital part of
the trustee's theory of recovery against the beneficiary of a transfer (or
against the initial transferee, where recovery is predicated on the presence
of a beneficiary).

According to this nexus requirement:

... [I]t is not enough that an insider be a creditor of the debtor in a general
sense; the insider must have a "claim" against the debtor attributable to the
specific debt he or she guaranteed in order to render transfers made by the
debtor on account of that debt to the non-insider transferee avoidable under
§ 547(b). 43

The nexus theory requires that the claims against the debtor must enjoy a
unity, such that payment or collateralization of one implies payment or
collateralization of the other, 46 or, in the alternative, that the debtor must
have intended that the transfer to the initial transferee benefit some spe-
cific antecedent debt owed to some other creditor. 47 If justified, this nexus

46 This branch of the requirement would cover the typical case where the debtor pays the as-
sured creditor, thereby relieving the surety of its suretyship obligation.
47 This branch of the requirement covers transfers to sureties for the benefit of an assured credi-
tor. E.g., Kellogg v. Blue Quail Energy, Inc. (In re Compton Corp.), 831 F.2d 586 (5th Cir. 1987),
modified, 835 F.2d 584 (1988) (per curiam). It also covers cases in which a creditor enjoying no
suretyship protection is simply paid or collateralized by a third party because the debtor transferred
assets to the third party in exchange for that payment. E.g., Dean v. Davis, 242 U.S. 438 (1917).

In Travelers Ins. Co. v. Cambridge Meridian Group, Inc. (In re Erin Food Servs., Inc.), 980
F.2d 792 (1st Cir. 1992), Judge Conrad Cyr ruled that the nexus theory absolutely required reduc-
tion of the joint debt. In Erin, the trustee could not show that the surety's claim against the debtor
was benefited by transfers to the assured creditor, because the surety was a nonrecourse secured party,
and the assured claim was well under water. The trustee therefore asserted that, because of payments
to undersecured creditors, bankruptcy was deferred—a benefit to the surety. Judge Cyr disagreed,
explaining that the deferral of bankruptcy was not reduction of debt because of the nexus
requirement makes it difficult for a trustee to export tripartite preference theory very far from the context in which the debtor is the principal obligor and one of the creditors is surety for the debtor. For example, no tripartite voidable preference case could be brought by the surety’s bankruptcy trustee, if the nexus requirement exists.\(^4\)

The second branch of the nexus requirement—founded upon the debtor’s mental state—can be located in the language of section 547(b) itself. According to section 547(b)(2), a transfer or the benefit emanating therefrom must be “for or on account of” an antecedent debt.\(^4\) This language suggests that the transfer must be laden with purpose—that the debtor must intend to connect a transfer to a specific debt. Furthermore, the hypothetical liquidation test in section 547(b)(5) refers to a hypothetical bankruptcy dividend on “such debt”—the debt a transfer was intended to benefit.\(^5\) That is, the benefit intentionally allocated to a certain, singular debt must be compared to the hypothetical liquidation dividend that the very same debt would generate. Thus, the nexus requirement could be grounded in the language of section 547(b). If this analysis holds, an incidental benefit or even a simple intent to benefit a person who happens by coincidence to have a claim against the debtor is not good enough.

Meanwhile, the first branch of the nexus requirement—unity of claims of two creditors held independently against the debtor—can be seen as a special case of the second branch. If two claims are really one claim—as in the case of suretyship—then the natural consequence of paying or collateralizing one claim is to pay or collateralize the other. Intent contemplates not only the direct anticipation of cause and effect, but also

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For a description of the hypothetical liquidation test, see supra note 11.
the launching of a cause with knowledge that the effect is certain to follow. The nexus between benefit and debt, then, is forged by the will of the debtor and is reduced to a question of the debtor's intent to pay or secure a specific antecedent debt.

A nexus requirement can also be drawn directly from the Deprizio holding. In Deprizio, Judge Frank Easterbrook ruled that the trustee could recover a benefited creditor's voidable preference from an innocent "initial transferee," but he could not recover withholding tax paid to the Internal Revenue Service based upon the theory that insiders were likewise benefited from such payments. The insiders did indeed benefit from payment of withholding tax. Because those taxes were paid, the insiders avoided "responsible person" liability under section 6672(a) of the Internal Revenue Code. But, as a matter of state law such liability would generate no claim over against the debtor. Such indemnity rights are unavailable in the area of intentional torts, Judge Easterbrook predicted.

It is quite apparent that these same insiders were "creditors" of the debtor. They had, for example, suretyship claims against the debtor arising from loan transaction claims which were the very basis of Deprizio's famous holding. Yet, even though the insiders were "creditors" who received the "benefit" of avoiding control person liability under section 6672(a), Easterbrook refused to find them liable. Their immunity from liability necessarily implies a nexus requirement.

81 ReSTATEMENT (SECOND) OF TORTS § 8A (1965) (intent exists when "the actor desires to cause consequences of his act, or that he believes that consequences are substantially certain to result from it").
82 Levit v. Ingersoll Rand Fin. Corp., 874 F.2d 1186, 1191-92 (7th Cir. 1989).
83 Id.
84 Id. (citing I.R.C. § 6672(a) (1988)).
85 Id. at 1192. Judge Easterbrook apparently assumed this to be a matter of state law and noted that at common law no indemnity claim could exist in favor of the intentional or reckless tortfeasor. Id. (citing W. PAGE KEETON, PROSSER AND KEETON ON TORTS 343 (5th ed. 1984)). This suggests that state governments might specifically create indemnity rights in trust fund tax cases, thereby rendering the IRS liable to return any trust fund taxes received with 90 days of bankruptcy and delivering a severe blow to public tax collection.

Fortunately for the IRS, the Supreme Court short-circuited this threat. In Begier v. Internal Revenue Serv., 496 U.S. 53 (1990), Justice Thurgood Marshall ruled that the entire bankrupt estate is held in trust for any withholding taxes which, if they remain unpaid, will give rise to § 6672(a) liabilities. Id. As a result of this holding, any payment to the IRS is not a transfer of property of the debtor, and payment of such taxes can never be a voidable preference. See generally Wayne Rodney, Note, The Non-Traceable 7501 Tax Trust and Bankruptcy Superpriority, 14 CARDOZO L. REV. 449 (1992).
At least one case expressly rejects the nexus requirement. In *Johnson v. NBD Park Ridge Bank (In re Octagon Roofing)*,77 a surety filed for bankruptcy. As we have seen, any claim by the surety’s bankruptcy trustee based upon a tripartite voidable preference theory violates the nexus requirement.8 Yet, in *Octagon Roofing*, the surety’s trustee prevailed.

The debtor in *Octagon Roofing* was a subsidiary and surety to its spendthrift parent. The surety issued a security interest to the assured creditor for the antecedent suretyship obligation and also for an antecedent debt that the surety happened to owe the assured creditor independently. The security interest was more than ninety days but less than a year old at the time of the surety’s bankruptcy. Therefore, the surety’s bankruptcy trustee had to show that the transfer to the assured creditor “benefited” the parent. If so, then, per *Deprizio* the assured creditor was liable as the “initial transferee” of another’s voidable preference.9

Judge Jack Schmetterer found a benefit to the insider: the grant of the security interest caused the principal obligor to forbear from enforcing its claim against the insider.60 This benefit bore no “nexus” with the claim owned by the insider against the debtor. Insofar as the suretyship relation was concerned, the insider had no claim against the debtor. On the contrary, the debtor had a claim against the insider. Nevertheless, the insider was additionally a creditor for other, unrelated matters. It was a “benefited” creditor and hence liable for the surety’s grant of a security interest to the assured creditor. According to Judge Schmetterer:

> There is nothing in *Deprizio*, or in any cases which have followed the reasoning of the *Deprizio* court, which suggests that the benefit to the inside creditor must be monetary in nature and cannot include forbearance such as that exercised by the Bank in favor of [the insider].81

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78 See supra notes 45-48 and accompanying text.
79 Another feature of *Octagon Roofing* is that the assured creditor claimed a security interest for two different debts—-one a claim against the surety of an insider and one on account of its own claim. The security interest was voidable as to the former, under the anti-nexus interpretation of *Deprizio*. The other was on antecedent debt, although it was valid because the security interest was more than 90 days old at the time of the bankruptcy and was not for the benefit of any insider.

Since every separate advance gives rise to separate security interests, the security interest for the suretyship might have been stricken on a *Deprizio* theory, but the other security interest for the antecedent debt should have been upheld. Judge Jack Schmetterer, in considering the secured party’s motion to dismiss the complaint for failure to state a cause of action, implied that the entire security interest was void, even for the antecedent debt.

80 124 B.R. at 532.
81 Id.
Of course, we have seen that *Deprizio* does indeed imply the nexus requirement's existence and is therefore in contradiction with the result in *Octagon Roofing*.

*Octagon Roofing*, if correct, opens up new vistas of voidable preference liability. Under *Octagon Roofing*, insiders who are creditors of the debtor will be liable for anything paid to other creditors, provided that the insider somehow "benefited" by the transfer.

5. *Junior Secured Parties*

Transfers to senior oversecured creditors disencumber collateral for the benefit of the junior secured party. Without the reference to the benefited junior secured party, these transfers are not directly recoverable from the senior secured creditor under section 547(b), because such payments supposedly cannot be challenged under the hypothetical liquidation test. But these same payments benefit the undersecured junior secured party, who might therefore be liable for them. By way of example, suppose that A is senior to B. Both A and B each claim $100, but the total collateral is worth $150. Accordingly, B is undersecured and can expect only $50 of collateral. If the debtor pays A $10, and the collateral retains its value of $150, B has benefited. B's collateral has improved from $50 to $60. B's benefit, then, precisely equals the $10 payment.

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62 It did so in the context of its ruling that the IRS did not have to return all withholding taxes paid one year before the bankruptcy. See supra notes 52-56 and accompanying text.

63 Two other authors have suggested that transfers to a subsidiary of the lender benefit the lender and are therefore recoverable from the lender. Craig H. Averch & Michael J. Collins, *Avoidance of Foreclosure Sales as Preferential Transfers: Another Serious Threat to Secured Creditors?,* 24 TEXAS TECH L. REV. 985, 1012 (1993). Such a veil-piercing proposition also contradicts the nexus requirement.

For other sources denying a nexus requirement, see Peter A. Alcés, *Rethinking Professor Westbrook's Two Thoughts About Insider Preferences, 77 MINN. L. REV. 605, 625 (1993)*; Donald W. Baker, *Repayments of Loans Guaranteed by Insiders as Avoidable Preferences in Bankruptcy: Deprizio and its Aftermath, 23 U.C.C.L.J. 115, 145-46 (1990).*

64 As always, if the junior creditor has received the voidable benefit of transfers to the senior secured party, then, under *Deprizio*, the senior secured party must pay, as initial transferee of these preferences. See infra notes 322-33 and accompanying text.

65 The hypothetical liquidation test protects any transfer to an oversecured party. 11 U.S.C. § 547(b)(5) (1988). For some heretical suggestions to the contrary, see Carlson, *supra* note 11.


67 By implication, the $10 payment is not cash proceeds of A's security interest. If the $10 is already encumbered, its surrender to A does not benefit B, because the payment implies that collateral has shrunk from $150 to $140.

68 In suretyship cases, courts have learned to impose a nexus requirement in tripartite voidable preference cases. See supra notes 45-63 and accompanying text. According to this nexus requirement,
Furthermore, A, the oversecured party, will be liable as well, under a Deprizio theory. Whereas Congress has repealed Deprizio when the trustee attempts to recover from the initial transferee for transfers more than ninety days before bankruptcy, it has left untouched the premise of Deprizio in all other cases.\textsuperscript{69} Hence, where an oversecured creditor has received transfers benefiting the junior secured party, the senior oversecured party is still liable for the voidable preference.

The leading case holding B liable for transfers to A is In re Prescott,\textsuperscript{70} where A—a bank—was undersecured until it received various transfers. After these transfers, A was oversecured. Accordingly, the first few increments of transfer, which caused A to improve its position, did not benefit B directly.\textsuperscript{71} But after A was fully secured, every unencumbered dollar transferred to A benefited B pro tanto.

In Prescott, A received three kinds of transfers: (1) additional collateral that B could not claim; (2) funds deposited in an overdrawn checking account; and (3) additional deposits in the checking account beyond the overdrawn amount.\textsuperscript{72} Later, the resulting positive balance was offset by A, thereby reducing the amount of the senior secured claim.

The first of these three transfers—the assignment of additional collateral to A—was clearly for the benefit of B, once A was oversecured.

the debtor must intend a benefit in connection with a single debt which is owed to one creditor and guaranteed by another. Intent, however, contemplates not merely the desire for the result, but also the conscious invocation of a cause with the knowledge that the effect must necessarily follow. On this latter definition of intent, tripartite cases involving junior and senior creditors meet the nexus requirement. It is a natural consequence of transfers to the senior secured creditor that the junior undersecured creditor is rendered more secure.

\textsuperscript{69} Once again, new § 550(c) provides:

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.


\textsuperscript{70} 805 F.2d 719 (7th Cir. 1986).

\textsuperscript{71} Travelers Ins. Co. v. Cambridge Meridian Group, Inc. (In re Erin Food Servs., Inc.), 980 F.2d 792 (1st Cir. 1992); \textit{but see} Cannon Ball Indus., Inc. v. Sequa Corp. (In re Cannon Ball Indus., Inc.), 150 B.R. 929, 932 (Bankr. N.D. Ill. 1992) (taking the position that such increments move a "person benefited" closer to direct benefit and so are themselves benefits). These holdings are discussed supra notes 25-31 and accompanying text.


\textsuperscript{72} 805 F.2d at 721.
Under ordinary principles of marshaling of assets, additional collateral available to A resulted in additional collateral available to B.

The deposits in the checking account, to the extent they covered the overdrafts, were also clearly transfers for the benefit of B. Such deposits were not setoffs but payments of a senior debt owed to A. Since these deposits were not distinguishable from any other payment of senior debt, B received a benefit.

The most difficult question was whether the setoff of deposits beyond the amount of the overdrafts could be recovered from B. Judge Robert Martin had ruled that this setoff was a transfer for the benefit of B, thereby making the junior party liable for its value.

That setoffs implicate transfers by a debtor may seem surprising at first. But, especially after the 1994 amendments to the Bankruptcy Code, the proposition cannot be denied. Even before the first amendment to section 500 in 1984, one might have observed that the mere existence of a setoff opportunity not yet exercised implies that a creditor has a secured claim in bankruptcy.

The doctrine of marshaling assets is an equitable rule for the benefit of junior secured parties. According to this doctrine, if the senior secured party has two pools of collateral—one encumbered by a junior security interest and the other not—the senior secured party should look to the singly encumbered collateral before pursuing the doubly encumbered collateral. The doctrine of marshaling applies only if it causes no inconvenience to the senior secured party of any kind. Moses Lachman, Note, Marshaling Assets in Bankruptcy: Recent Innovations in the Doctrine, 6 CARDOZO L. REV. 671, 672-73 (1985).

The collateral in question was a certificate of deposit, apparently payable by some other bank. See Armstrong v. Marine Bank Dane County (In re Prescott), 51 B.R. 751, 753-54 (Bankr. D. Wis. 1985) (senior-secured party said to have "cashed the certificate of deposit"), aff'd, 805 F.2d 719 (7th Cir. 1986). A "certificate of deposit" is simply a bank's unsecured obligation to pay. U.C.C. § 3-104(j) (1978). If the debtor had "pledged" the senior secured party's own certificate of deposit over the senior secured party, the senior secured party would have had a setoff opportunity, not an Article 9 security interest.

Under the former Bankruptcy Act, courts usually denied that setoffs were transfers of debtor property. National Bank of Newport v. National Herkimer County Bank, 225 U.S. 178, 185 (1912) ("The fact then is not . . . that 'the bankrupt parted with property . . . and the bank received it,' but rather that the bankrupt parted with nothing, and the bank received then money of the [affiliate] and redelivered to the [affiliate] the paper and collateral."); New York County Nat'l Bank v. Massey, 192 U.S. 138, 147 (1904) ("A deposit of money . . . in a bank does not operate to diminish the estate of the depositor. It is not a transfer as security . . ."); but see Katz v. First Nat'l Bank of Glen Head, 568 F.2d 964, 970 (2d Cir. 1977) (setoffs could be transfers if they were fraudulent attempts to loot the debtor's estate).

See 11 U.S.C. § 506(a) (1988) ("An allowed claim of a creditor . . . that is subject to setoff under section 553 of this title, is a secured claim to the extent of the . . . amount subject to setoff . . .").
debtor. In 1984, Congress erased doubt by amending section 550(a) to read:

to the extent that a transfer is avoided under section . . . 553(b) . . . the trustee may recover . . . the property transferred, or, if the court so orders, the value of such property, from (1) the initial transferee of such transfer or the entity for whose benefit such transfer was made . . . .

Section 553(b) is a setoff rule that attempts to prevent improvement in position by a creditor over the life of the preference period. In section 550(a), the avoided setoff is specifically labeled a “transfer.”

The reference in section 550 to setoffs was added in 1984, and, on appeal, Judge Richard Cudahy thought he had to apply the pre-1984 statute to the setoff in question. Nevertheless, Judge Cudahy ruled that the 1984 amendment to section 550(a) simply made explicit an earlier intent of Congress with regard to setoffs that benefit third parties.

But when did the setoff become a transfer? In Prescott, all the surplus deposits in the checking account, plus the setoff itself, occurred within the preference period, and so the exact moment of the transfer did not have to be identified. Under any assumption, B received the benefit of

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79 Oddly, setoffs that violate § 553(b) are transfers, but setoffs that violate § 553(a) are not likewise labeled in § 550(a).

It may also be noted that, after 1984, the trustee could have prevailed against B for A’s setoff without any reference to voidable preference law. Rather, the trustee could show that the entire setoff constituted an improvement of position under § 553(b)(1). Section 553(b)(1) provides, in relevant part:

[If] a creditor offsets a mutual debt owing to the debtor against a claim against the debtor on or within 90 days before the date of the filing of the petition, then the trustee may recover from such creditor the amount so offset to the extent that any insufficiency on the date of such setoff is less than the insufficiency on the later of- (A) 90 days before the date of filing of the petition; and (B) the first date during the 90 days immediately preceding the date of the filing of the petition on which there is an insufficiency.

11 U.S.C. § 553(b)(1) (1988 & Supp. II 1990). Section 553(b)(2) defines “insufficiency” to be “amount, if any, by which a claim against the debtor exceeds a mutual debt owing to the debtor by the holder of such claim.” Id.

A was liable for the illegal setoff, although any amount returned because the setoff was illegal could be recouped from the valid collateral the senior secured party may have held. But B was likewise liable under § 553(b). Section 550(a) specifically makes an “entity for whose benefit such transfer was made” liable for setoffs by another. Since B was the “entity for whose benefit such transfer was made,” the trustee could have dunned B under § 553(b) and § 550(a)(1) without ever relying on § 547(b).

80 Prescott, 805 F.2d at 731.
81 Id. at 722.
of a transfer to A within the preference period. On the other hand, suppose the surplus deposits occurred before the beginning of the preference period, and the actual setoff occurred within the ninety day period. For timing purposes, which event constitutes the transfer?

The better view is that the creation of the setoff opportunity—not the actual setoff—is the moment of the transfer. The creation of mutual debts is what makes the creditor a secured creditor in bankruptcy. This justifies the conclusion that the key moment is when A obtained the deposits (where a countervailing debt already exists) or when A's claim against the debtor first arose (where the deposits have already been made). The actual manifestation of the setoff is akin to a foreclosure—not the creation—of the implicit security interest. Hence, if A took surplus deposits before the preference period, the transfers would have been for the benefit of B, but these benefits would not have been voidable because they did not occur within ninety days of bankruptcy.

Thus, A's valid setoff opportunity may constitute B's voidable preference, when the debtor's claim against A (the setoff opportunity) arose within the preference period. Since she is the initial transferee of this setoff, A shares liability according to Deprizio because B was benefited. This is a surprising result when section 553(a) explicitly blesses A's setoff.

A final point about Prescott should be made. It was almost certainly wrongly decided! The analysis in both court opinions assumes that the dollars deposited in the checking account and later set off by A were unencumbered dollars, not cash proceeds encumbered by the senior security interest. Since the debtor was a grocery store, income probably came from the sale of encumbered inventory, and it is likely that all amounts deposited in the checking account were indeed cash proceeds.

When a debtor deposits cash proceeds already belonging to a bank in a checking account, the bank does not thereby become obligated for these funds to the debtor, as would be the case if unencumbered dollars were deposited. Accordingly, when the bank later asserts its prior right to these cash proceeds by debiting the checking account, the bank is not exercising a setoff right at all. For example, the trustee could not claim that an improvement in position occurred within the meaning of section 553(b), for the simple reason that the cancellation of the checking account is not a setoff right.

See 11 U.S.C. § 506(a) (1988) (“An allowed claim of a creditor . . . that is subject to setoff under section 553 of this title, is a secured claim to the extent of the . . . amount subject to setoff . . . .”)

“setoff” when the account has only cash proceeds in it.\textsuperscript{84}

Meanwhile, repossession of cash proceeds that \( A \) already owns cannot possibly benefit \( B \). For every encumbered dollar \( A \) expropriates to extinguish the senior claim, a dollar of collateral disappears.\textsuperscript{86} \( B \) is not enriched. Therefore, the trustee should not have been able to claim that the “setoff” benefited \( B \) at all. To the extent that the deposits were cash proceeds that otherwise belonged to \( A \), the \textit{Prescott} case was wrongly decided.

6. \textit{Cost of Maintaining Collateral}

If transfers to senior secured creditors generate liability for benefited junior undersecured creditors, then the path is open to a much more subversive idea—that any payment to a supplier or an employee tending to maintain or improve the value of collateral is a preferential benefit chargeable to a secured creditor.

Thomas M. Ward and Jay A. Shulman, writing early in the career of the Bankruptcy Code, anticipated this radical possibility.\textsuperscript{86} They thought that the word “benefit” might contemplate payments to those who helped improve the value of collateral. For example, if a worker improved the value of collateral and then received payment of wages, the payment “benefited” the secured party, thereby justifying a voidable preference recovery.\textsuperscript{87} Furthermore, the secured party would be liable as a “benefited” party even when the payment to the employee or supplier is fully secured or a contemporaneous exchange. Such facts relieve the supplier of liability under section 547(b), but not the secured party, for whom the benefit is on antecedent debt. Meanwhile, even if the suppliers are immune under section 547(b), they are vulnerable under \textit{Deprizio}, thereby giving the bankruptcy trustee the option of undoing payment of payrolls, suppliers, and the like.

Assuming no defense applies to aid the secured creditor, this broad definition of “benefit” invokes for the prepetition period a principle analo-\textsuperscript{84} 805 F.2d at 289-90; \textit{see also} Quinn \textit{v.} Montrose State Bank \textit{(In re Intermountain Porta Storage, Inc.)}, 74 B.R. 1011 (D. Colo. 1987) (denying that U.C.C. § 9-306(4)(d) changes such a result); Wear \textit{v.} Buffalo Bank \textit{(In re 4-S Corp.)}, 69 B.R. 499 (Bankr. W.D. Mo. 1987) (setoff of bank account containing only cash proceeds held to be foreclosure of security interest on these funds). \textit{See} Carlson, \textit{supra} note 11.

\textsuperscript{86} For this reason, a surrender of cash collateral never constitutes a voidable preference because the surrender never falls afoul of the hypothetical liquidation test. \textit{See} Carlson, \textit{supra} note 11.

\textsuperscript{87} Ward & Shulman, \textit{supra} note 11, at 38-39.
gous to the one that section 506(c) invokes for the postpetition era. Ac­
cording to section 506(c):

The trustee may recover from property securing an allowed secured claim
the reasonable, necessary costs and expenses of preserving, or disposing of,
such property to the extent of any benefit to the holder of such claim. 88

By referring to trustee expenses, section 506(c) at least hints that the trus­
tee can recover only the postpetition expenses of collateral maintenance. 89
Under the Ward-Shulman analysis, voidable preference law manages to
extend the trustee's section 506(c) power to the prepetition period. The
strength of this theory, however, is much mitigated by the fact that sec­
cured creditors can invoke the section 547(c)(2) defense which protects
ordinary course payments. 90 Hence, only unusual activity will generate
voidable preference liability for benefits bestowed on collateral by employ­
ees and suppliers. 91

7. Collection Prowess

According to Judge Will Garwood in T.B. Westex Foods, Inc. v.
Federal Deposit Insurance Corp. (In re T.B. Westex Foods, Inc,), 92
the collection prowess of a secured party claiming receivables constitutes a
benefit to the debtor. 93 Thus, when the account debtor files for bank­
ruptcy, the account debtor’s trustee may recover the value of what is paid
to the secured party from the debtor to whom the account debtor origi­
nally owed the debt. Although Westex involved judicial liens, if translated
into the context of accounts receivable financing under Article 9, the case
progressed as follows.

Suppose D and SP sign a security interest whereby D assigns his
receivables to SP. One account debtor (AD) also happens to be a subsidi­
ary of D. D defaults and SP collects directly from AD. AD pays and
quickly files for bankruptcy. If benefit can be located, SP and D are both
liable for the voidable preference.

88 11 U.S.C § 506(c) (1988).
89 But see Irving A. Breitowitz, Article 9 Security Interests as Voidable Preferences: Part II The
Floating Lien, 4 CARDOZO L. REV. 1, 133 n.380 (1982).
91 As to how this theory survives the nexus requirement, see supra note 68. The nexus require­
ment is described supra in the text accompanying notes 45-63.
92 950 F.2d 1187 (5th Cir. 1992).
93 Id.
In *Westex*, Judge Garwood asserted that benefit to the insider accrued because *SP* collected more from *AD* than *D* would have.\(^4\) The extra collection therefore effectively extinguished more of *D*’s obligation to *SP* than would have been the case if *D* collected and surrendered the proceeds to *SP* indirectly.\(^6\) Because of this “benefit,” the insider was liable for a voidable preference.\(^6\)

That *D* benefited because *SP* collected debts owed by *AD*\(^7\) is surprising\(^8\) because, in the *Westex* case, *D* was the president of *AD*, and could simply have written himself a check on behalf of *AD*. But Judge Garwood’s conclusion is simply the logical implication of the hypothetical liquidation test of section 547(b)(5). According to that provision, a transfer is voidable only if it:

> 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 . . . .\(^9\)

As applied to *Westex*, the hypothetical liquidation test requires us to imagine that *SP* has returned the collections to *AD*’s trustee and that *D* has entered the bankruptcy as an unsecured creditor collecting a dividend. By definition, whenever *AD* is insolvent, *SP*’s collection allowed *D* to “receive more” than the hypothetical liquidation dividend of section 547(b)(5)(C).\(^10\)

Notice that the hypothetical liquidation test does not allow us to imagine that, instead of *SP*’s collection, *D* used his power as president of *AD* to write himself a check for the amount *AD* owed. The only thing that

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\(^4\) *Id* at 1192-93.

\(^5\) *Id*.

\(^6\) This holding would appear to meet the first prong of the nexus requirement: the claims against the debtor enjoyed a unity, such that payment or collateralization of one claim implies extinguishment or collateralization of the other. *D* as assignor and *SP* as assignee each had a separate claim against the debtor, but *AD* owed only a single debt.

\(^7\) In fact, *SP* did not garnish *AD* but *AD*’s bank, because *AD* was refusing to pay *SP* under the garnishment. This makes no analytical difference. Whether *AD* paid voluntarily or whether *AD*’s property was levied upon, *SP* is alleged to have been a superior collector than the company of which *D* was the president.

\(^8\) Without considering these facts too deeply, the reader may wonder how likely it is that *D* will think, “Thank heaven. My property has been garnished.” Yet that is precisely what Judge Garwood implied in holding that *D* obtained a benefit when its account debtor suffered a transfer to *SP*.


\(^10\) That this is true by definition is established in Carlson, *supra* note 11.
may be compared to SP’s collection is the dividend in AD’s hypothetical chapter 7 liquidation. Therefore, the superior collecting prowess of SP is nothing more than the logic of the hypothetical liquidation test playing itself out.

It may also be noted that if AD paid D directly, D would have received a clear voidable preference because D was an insider. Any such payment to D would be recoverable by AD’s bankruptcy trustee,101 and D would be reduced to a pro rata dividend. But because SP was paid, and because more than ninety days had elapsed, D enjoyed the benefit of having his own debt reduced, because SP was immune from voidable preference liability. For these reasons, Westex was correctly decided on the question of benefit to D.102

B. Antecedent Debt

A loan agreement and a suretyship agreement are often executed simultaneously. In this context, security interests taken by the surety are not voidable preferences, if promptly perfected. Such security interests are contemporaneous exchanges, not transfers on antecedent debt.103

Alternatively, the surety’s security interest may be a transfer to the surety on antecedent debt. Antecedence of debt could arise in three ways: (1) the loan agreement and suretyship agreement are coeval, but thereafter the debtor grants a security interest to the surety; (2) the assured creditor first extends the loan, and thereafter the suretyship agreement arises,

101 The cash actually paid by AD, however, would be cash proceeds belonging to SP. SP would be a transferee of a transferee within the meaning of § 550(a)(2) and therefore eligible for the defense in § 550(b), which provides:

The trustee may not recover under section (a)(2) of this section from— (1) a transferee that takes for value, including satisfaction or securing of a present or antecedent debt, in good faith, and without knowledge of the voidability of the transfer avoided... 11 U.S.C. § 550(b) (1988). SP’s liability as transferee of a transferee would then depend upon SP’s knowledge about the collection.

102 Later it will be pointed out that, when the trustee proves a benefit has occurred within the meaning of § 547(b)(1), the trustee has automatically proven that the hypothetical liquidation test of § 547(b)(5) has been met with regard to that creditor. See infra notes 133-40 and accompanying text. Westex may also be taken as authority for this proposition.

In Westex, even though AD’s trustee had a voidable preference action against SP, D’s bankruptcy trustee did not. The money AD paid to SP was a transfer of debtor property because this money represented proceeds of D’s claim against AD. But this same money also represented cash proceeds of SP’s security interest. Payment of unencumbered dollars may be a voidable preference, but surrender of cash proceeds encumbered by a valid security interest never is because such surrenders cannot meet the hypothetical liquidation test under § 547(b)(5). See Carlson, supra note 11.

secured by a simultaneously created security interest granted by the debtor to the surety; (3) the loan agreement and suretyship agreement are created simultaneously, but the surety does not perfect the security interest in a timely manner. Each of these examples poses its own special difficulty.

First, when the assured obligation and the suretyship are of equal age, the debtor may thereafter transfer collateral to the surety. In this first case, can it truly be said that the transfer is on antecedent debt so long as the surety has paid nothing to the assured creditor, the debtor does not yet “owe” the surety anything. A surety’s claim against the debtor at this point is merely contingent. According to section 547(b)(2), a voidable preference must be a transfer “for or on account of an antecedent debt owed by the debtor . . .”

In an earlier article, I tried to establish that a mere commitment to lend was not an antecedent debt—a proposition generally vital for secured transactions under Article 9 of the Uniform Commercial Code. According to section 547(b)(2), the debtor must actually “owe” the debt to the lender. If the lender has not advanced any funds, the debtor “owes” nothing, and therefore the commitment to lend is not itself an antecedent debt. This is so even though the Uniform Commercial Code defines the commitment to lend as “value”—one of the elements of attachment under Article 9.

If a commitment to lend is not an antecedent debt because the debtor does not owe anything, it must also follow that neither is the contingent suretyship claim. Without more, it would appear that no security interest granted to a surety while the suretyship claim is still contingent could be a voidable preference. This unacceptable result will be rejected in due course, but before a solution is offered, let us examine the second way a security interest may be a transfer on antecedent debt in a tripartite case: when the assured obligation arose first and then the suretyship obligation arose later. Contemporaneously with the suretyship agreement, the surety

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104 The first two security interests on antecedent debt will be considered in this section, and the third, old-fashioned late perfection of the security interest, will be considered in the next section.

105 As discussed earlier, controversy exists as to whether such a security interest “benefits” the assured creditor. See supra notes 32-35 and accompanying text. In any case, the surety is clearly liable for receiving a security interest on antecedent debt.


108 Carlson, supra note 11.

109 Id.

receives a security interest.

Here we clearly have a transfer of debtor property to the surety for the benefit of the assured creditor. Assuming all the other elements of section 547(b) are met, the assured creditor will be liable for the surety's security interest. The surety, however, will still be immune from liability because she will have a defense under section 547(c)(1).

In both these cases, a surety received a security interest at a time when the debtor owed nothing to the surety. Yet section 547(b)(2) requires that the security interest be “for or on account of an antecedent debt owed by the debtor before such transfer was made.” How can it be said that these security interests are transfers on antecedent debt? In particular, we wish in the first type of case to hold the surety liable for a voidable preference, and in the second case, we wish to hold liable the assured creditor, for whose benefit the security interest was granted.

The following theory should do the job. According to section 547(b)(2), the debtor must actually owe someone for an antecedent debt, but section 547(b)(2) does not specify to whom the debt must be owed. Thus, by virtue of its contingent claim, the surety is a “creditor” of the debtor under section 547(b)(1), and the antecedent debt is “owed” to someone other than the surety under section 547(b)(2). These observations imply that the surety has received a security interest on antecedent debt in both the first case, where the suretyship agreement is antecedent to the security interest, and in the second case where the suretyship agreement is contemporaneous with the security interest. Thus, a bank issuing a letter of credit to secure an assured creditor’s antecedent claim falls to the prima facie case under section 547(b). Such a bank, however, is likely to have a valid defense under section 547(c)(1). This matter will be dis-

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111 We assume here that the security interest was the sine qua non of the suretyship agreement and that the suretyship agreement was a benefit to the assured creditor. See supra note 32 and accompanying text.

112 If the insider also supplies collateral to the assured creditor and then files for bankruptcy, the assured creditor has received a voidable preference in the surety’s bankruptcy. Gill v. Winn (In re Perma Pac. Props.), 983 F.2d 964 (10th Cir. 1992).

113 Section 547(c) provides that the trustee may not avoid the 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 . . . .


114 Section 547(b) requires both the existence of a debtor-creditor relationship, and, separately, the establishment of an antecedent debt. 11 U.S.C. § 547(b)(1) (1988). Given that creditors can have purely contingent claims, the concept of antecedent debt and creditor status are by no means the same.
cussed in Part II.\textsuperscript{118} For now, the \textit{prima facie} case under section 547(b) affirms that, in the first two types of cases, both the assured creditor and the surety have received transfers on antecedent debt.\textsuperscript{116}

A security interest in the second type of case—where the assured claim is antecedent to the surety’s security interest—was illegitimately preserved from the \textit{prima facie} case in \textit{Kellogg v. Blue Quail Energy, Inc. (In re Compton Corp.)}.\textsuperscript{117} In \textit{Compton}, the debtor appeased an unpaid supplier with a bank’s standby letter of credit, which stated that the supplier could obtain payment from a bank on demand. In exchange, the bank automatically obtained a security interest pursuant to a future advance clause in a preexisting security agreement between the bank and the debtor. The day after the letter of credit was executed, creditors filed a bankruptcy petition against the debtor. A month later, the bank paid the supplier under the letter of credit. The bankruptcy trustee sued the supplier, but not the bank, for voidable preference liability.\textsuperscript{118}

The supplier moved for summary judgment on the theory that it had never received debtor property.\textsuperscript{119} This fact alone could not defeat the trustee because section 547(b) does not require the creditor to \textit{receive} debtor property. Section 547(b) applies if the creditor benefited when some other person received debtor property.\textsuperscript{120} Clearly, the supplier benefited when the bank received a security interest, thereby enabling the letter of credit to be issued. Nevertheless, both the bankruptcy and district courts awarded summary judgment in favor of the supplier, on the premise that liability was impossible if the supplier received no transfers of

\textsuperscript{118} \textit{See infra} notes 174-82 and accompanying text.

\textsuperscript{116} Another implication of this definition of antecedent debt is that, when a secured party takes an assignment of an unsecured claim from an unsecured creditor and brings it in under the security interest as if it were a future advance, the security interest created for the unsecured claim is on antecedent debt owed to the unsecured assignor, even though the assignee’s claim and the assignee’s security interest arose at the same time. Although courts have struggled to maintain the U.C.C. itself does not permit an assignee to fit the assigned claim under a security agreement without the consent of the debtor, \textit{Republic Nat’l Bank v. Fitzgerald (In re E.A. Fretz Co.)}, 565 F.2d 366 (5th Cir. 1978), a different answer is that the security interest is on antecedent debt and hence possibly a voidable preference. \textit{See F. Stephen Knippenberg, Future Nonadvance Obligations: Preferences Lost in Metaphor}, 72 WASH. U. L. REV. 1537, 1598 (1994).

\textsuperscript{117} 831 F.2d 586 (5th Cir. 1987), \textit{reh’g} granted, 835 F.2d 584 (5th Cir. 1988) (per curiam).

\textsuperscript{119} \textit{Id.} at 589. The supplier also tried to force the bank to indemnify it because of the supplier’s voidable preference liability. \textit{Id.} at 596 (“We affirm the district court’s dismissal of Blue Quail’s request to proceed against MBank for reimbursement.”).

\textsuperscript{120} 831 F.2d at 589.

\textsuperscript{121} \textit{See also} \textit{American Bank v. Leasing Serv. Corp. (In re Air Conditioning, Inc.)}, 845 F.2d 293, 297 (11th Cir.), \textit{cert. denied sub nom.} First Interstate Credit Alliance, Inc. v. American Bank, 488 U.S. 993 (1988).
debtor property. On appeal to the Fifth Circuit, Judge Jerre Williams reversed.

With regard to the bank, Judge Williams noted that the bank’s future advance clause under a security agreement was executed almost two years prior to the filing of bankruptcy. Judge Williams reasoned that the security interest was transferred more than a year before bankruptcy, even though the bank issued the letter of credit one day before bankruptcy. According to Judge Williams:

The transfer to MBank of the increased security interest was a direct transfer which occurred on May 6, 1982, when the bank issued the letter of credit. Under 11 U.S.C. § 547(e)(2)(A), however, such a transfer is deemed to have taken place . . . at the time such transfer “takes effect” between the transferor and transferee if such transfer is perfected within 10 days. The phrase “takes effect” is undefined in the Bankruptcy Code, but under Uniform Commercial Code Article 9 law, a transfer of a security interest “takes effect” when the security interest attaches. Because of the future advances clause in MBank’s 1980 security agreement . . . the attachment of the . . . security interest relates back to . . . the date the security agreement went into effect. 

This relation back of the security interest to the time of the security agreement was error, albeit harmless. Because the advance was discretionary on the part of the bank, the security interest arose only when the advance was made. Indeed, Judge Williams’ conclusion potentially violated sec-

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121 The district court also ruled that the security interest to the bank was not for the benefit of the supplier. 831 F.2d at 589. Both of these propositions will be refuted later.
122 831 F.2d at 591.
123 Cf. Luring v. Miami Citizens Nat’l Bank & Trust Co. (In re Val Decker Packing Co.), 61 B.R. 831 (Bankr. S.D. Ohio 1986). In Val Decker Packing, a bank had issued a letter of credit, but the security agreement specified that only debt evidenced by a promissory note could be brought in under the future advance clause. As a result, when the debtor finally did sign a note, the debt came under the security agreement, and a security interest finally attached. Unfortunately, it attached during the preference period and constituted a voidable preference for the bank. The restrictive future advance clause therefore had the effect of a “deferred attachment” clause, with the usual disastrous consequence that such clauses have.
124 Thus, the debtor paid $1,463 to issue the letter of credit. Id. at 589.
125 U.C.C. § 9-203(1)(b) (1978). Judge Williams’ holding on the timing of the transfer might be compared with Judge Shirley Hufstedler’s famous timing rule in DuBay v. Williams, 417 F.2d 1277 (9th Cir. 1971). In DuBay, Hufstedler ruled that a security interest is deemed transferred, for voidable preference purposes, when a financing statement is filed, even though an element of attachment—the debtor has rights in collateral—is missing. Id. at 1287-88. In Compton, Williams also held that the transfer existed even in the absence of a different element of attachment—the creditor’s gift of value.
tion 547(e)(3), which provides: "[f]or the purposes of this section, a transfer is not made until the debtor has acquired rights in the property transferred." Judge Williams did not describe the collateral claimed by the bank, but if the debtor acquired any of the collateral after the security agreement was signed in 1980, then dating the transfer back to the time of the security agreement transgressed section 547(e)(3).

In any case, while the bank could view the transfer as having occurred more than a year before the bankruptcy, the supplier could not, according to Williams, because the supplier was not a party to the bank's security agreement.\(^{126}\) Therefore, the court reversed and held that the supplier, having received the benefit of a voidable preference, was liable under section 550(a)(1).

It is odd that a transfer considered to be a year old for the bank was considered freshly made for the benefit of the supplier. The better view is that the transfer arose at precisely the same time for both the bank and the supplier. So far as both creditors were concerned, the security interest was a transfer on antecedent debt.\(^{127}\) Meanwhile, the bank had a valid defense under section 547(c)(1)—a defense not available to the supplier. Once again, the nature of this defense will be taken up later.\(^{128}\)

1. Late Perfection

The previous section considered two types of transfers on antecedent debt in tripartite cases. The third way a surety's security interest may also

\(^{126}\) 831 F.2d at 591.

\(^{127}\) Two commentators suggest that, even though the security interest to the issuing bank in a case like Compton should not be vulnerable, a trustee should be able to obtain an injunction against the bank preventing distributions under the letter of credit whenever the letter of credit results in a preference for the benefit of an unsecured or undersecured creditor. Steven R. Gross & Peter L. Borowitz, A New Twist on Twist Cap: Invalidating a Preferential Letter of Credit in In re Air Conditioning, 103 BANKING L.J. 368 (1986). Such an injunction would not harm the bank since it would not have to pay out any funds, and the beneficiary of the letter of credit deserves no solicitude since the letter of credit constitutes the benefit of the bank's collateral. Nevertheless, one problem with this idea is that it permits the debtor's trustee to protect the debtor's in rem rights in the bank's would-be collateral, whereas the debtor's cause of action against the benefited creditor would have to be an in personam action for the value of the collateral. If the benefited creditor is herself bankrupt, then the Gross-Borowitz theory creates a preference for the original debtor's trustee, at the expense of the unsecured creditors of the beneficiary. It is not clear why the trustee of the bank's customer deserves a priority over the trustee of the beneficiary of the letter of credit.

\(^{128}\) See infra notes 186-206 and accompanying text. Because the supplier had the benefit of a voidable preference, the bank might have been liable too, on a Deprizio theory, in spite of the contemporaneous exchange or Judge Williams' dubious relation back theory. Judge Williams refused to follow what would later become the Deprizio theory, on grounds that are, with some revisions, quite convincing. It is best to consider these grounds in the context of the § 547(c)(1) defense.
be a transfer on antecedent debt occurs when the surety neglects to perfect her security interest, thereby deferring the time of the transfer. This principle, simple enough when abstractly pondered, becomes complicated in the case of suretyship for discretionary advances.

By way of illustration, suppose the surety promises on January 1 to guarantee an advance that the assured creditor makes on January 1. On January 1, the debtor grants a security interest to the surety. The secured party perfects on January 12. Thanks to the deferral rule of section 547(e)(2)(B), the security interest is deemed transferred to the surety on January 12. It is potentially a voidable preference, if the other elements of section 547(b) have been met.

Suppose, however, that the advance is not made on January 1. Instead, the assured creditor has discretion to make advances, and the surety promises to be liable for any such advance, if it is ever made. Furthermore, the debtor and the surety sign a security agreement on January 1, but the surety forgets to perfect until January 12. Finally, the assured creditor advances funds on February 1, at a time when the security interest is perfected. Is this a transfer on antecedent debt?

There are two schools of thought. On the one hand, the surety had a contingent claim on January 1—based on its commitment to guarantee repayment of an advance the assured creditor is not bound to make. On the other hand, it had a contingent claim on February 1, when the advance was actually made. Which of these two dates count? The voidability of the security interest depends on the choice.

The better choice is February 1. Prior to February 1, the extent of the obligation was zero. Even though the surety committed herself on January 1, no antecedent debt existed until funds were actually advanced on February 1. The security interest attached, and was perfected, on February 1, suggesting that the security interest is not a voidable preference.

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129 E.g., Taunt v. Fidelity Bank (In re Royal Golf Prods. Corp.), 908 F.2d 91 (6th Cir. 1990).
130 It is possible that § 547(c)(1) might provide a defense, since the transaction was intended to be a contemporaneous exchange of values and, but for the perfection mistake, was substantially so. A great many courts, however, believe that § 547(c)(1) can never be used to correct perfection mistakes because that would render the grace period in § 547(e)(2)(A) superfluous. See Carlson, supra note 11.
131 This is an application of the rule that commitments to lend are not antecedent debts until the debtor actually owes the repayment. See supra notes 108-10 and accompanying text.
132 It may be noted that the new Uniform Fraudulent Transfer Act makes an obligation effective when a "writing executed by the obligor is delivered to or for the benefit of the obligee." U.F.T.A. § 6(5) (1985). This language implies that the suretyship is an obligation on January 1, long before
C. The Hypothetical Liquidation Test

Suppose an outside creditor receives a security interest between ninety days and one year before the bankruptcy. An insider is benefited. The debtor is insolvent, and the transfers were within the insider preference period of one year. How do these transfers meet the hypothetical liquidation test under section 547(b)(5), insofar as the benefited creditor is concerned?

One commentator, Mark Toth, denies that they do:

[I]f the inside guarantor managed to pay the outside creditor in full [with debtor property], the inside guarantor would have no claim at all in bankruptcy and would receive nothing. Under this analysis, payments made by an inside guarantor to an outside creditor are not avoidable because such payments do not enable the inside guarantor to receive more than if the payments had not been made.

The thrust of these remarks seems to be this: if the suspect transfers are returned to the bankrupt estate, as section 547(b)(5)(B) dictates, the surety has no allowable claim in the bankruptcy because the suretyship claim is still contingent. Therefore, the hypothetical liquidation dividend called for in section 547(b)(5) is zero. This must be compared with what the surety received in real life: nothing whatsoever. Therefore, according to Toth, the transfer cannot possibly meet the hypothetical liquidation test.

The controversial move in this interpretation is that "to receive more" in section 547(b)(5) means to receive more property. If so, then Toth is quite correct that transfers to assured creditors are not chargeable to insiders. One must concede, however, that the surety has obtained a great financial benefit by means of these transfers. If they are upheld,

the assured creditor makes a discretionary advance. The definition, however, is limited to "the purposes of this [Act]." Furthermore, the question at hand is whether the security interest of January 12 is for or on account of antecedent debt. As this latter term is from federal law, the bankruptcy courts should adopt a federal definition and ignore any contrary suggestion from the U.F.T.A.

The trustee would have to prove insolvency. The presumption of debtor insolvency covers only the 90 day period before bankruptcy. 11 U.S.C. § 547(f) (1988).


11 U.S.C. § 502(e)(1)(B) (1988). In other words, the debtor owes the surety no "an antecedent debt," consistent with what was said earlier. See supra notes 114-15 and accompanying text.
then the surety is relieved of a serious financial liability to the assured creditor.

Alternatively, if "receive more" is stretched to mean "obtained a benefit," then the commentator's point is wrong. The courts—though without analysis—routinely assume that "receive more" deserves the broad reading.\(^\text{187}\) Section 547(b)(2) favors a broad reading by targeting benefits that are not themselves transfers.\(^\text{188}\) If section 547(b)(2) takes the trouble to strike down improper "benefits," then "receives more" in section 547(b)(5) likewise must refer to improper benefits.

Under this reading, "receives more" is entirely redundant with the existence of a benefit under section 547(b)(2). That is, if the trustee has proved section 547(b)(2) against a non-transferee, the trustee has likewise proved the elements of section 547(b)(5) as well.\(^\text{189}\) In other words, the mere existence of a benefit establishes that the hypothetical liquidation test can be met.\(^\text{140}\)

It must be assumed, then, that "benefits" received by insiders are voidable within the meaning of section 547(b)(5). Nevertheless, ample valid collateral—granted either to the surety or to the assured creditor—will confound the hypothetical liquidation test and save either party from liability. For example, if the assured creditor is fully secured, a payment is still arguably not for the benefit of the surety. The surety is subrogated to any security interest of the oversecured party and therefore faces no loss in the debtor's bankruptcy. In addition, because the surety has subrogation rights and stands in the shoes of the secured creditor, the trustee cannot meet the hypothetical liquidation test against the surety.

\(^{187}\) Any court that has ever followed Deprizio implicitly makes this assumption.

\(^{188}\) This is, at least, the emerging view put forth in Deprizio. Some authorities would disagree and would assert that a benefit is itself a transfer separate from the initial transfer. This is known as the "two-transfer" theory, which is supposed to defeat the reasoning in Deprizio. See infra notes 302-22 and accompanying text.

\(^{189}\) Furthermore, "receives more" implies that a non-transferee defendant "receives" a benefit. The trope "receives more" therefore arguably assumes a "benefit" is a "transfer," because it is susceptible of receipt. This point, seemingly incoherent now, becomes important in our analysis of Deprizio later on. Whether a benefit is a "transfer" is essential in assessing whether Deprizio was rightly decided.

\(^{140}\) It is considered a high crime and misdemeanor to render statutory language superfluous. E.g., United Savings Ass'n of Texas v. Timbers of Inwood Forest Assoc., 108 S. Ct. 626, 630 (1988) ("Statutory construction . . . is a holistic endeavor."). I have done no such thing here. Even if § 547(b)(2) renders § 547(b)(5) superfluous in tripartite cases, it does not do so in bipartite cases, in which § 547(b)(5) plays a vital role indeed. Therefore, it is open for courts to recognize—indeed, it is impossible for them to deny—that the existence of a benefit under § 547(b)(2) satisfies the hypothetical liquidation test with regard to non-transferees.
1. The Surety As Owner of the Collateral

It should be apparent that if the assured creditor and the surety are unsecured, but the surety has provided collateral to the assured creditor, the assured creditor's security interest in the surety's assets can never be a voidable preference in the debtor's bankruptcy. This conclusion is supported by the fact that the debtor has not transferred property to another party.\textsuperscript{141} Nor can it be the case that the assured creditor is a secured creditor in the debtor's bankruptcy. Hence, if the assured creditor has a security interest only in assets of a surety, any transfer of debtor property to the assured creditor easily meets the hypothetical liquidation test of section 547(b)(5) and can be recovered by the debtor's trustee as a voidable preference.

In \textit{CEPA Consulting, Ltd. v. New York National Bank, Inc. (In re Wedtech Corp.)},\textsuperscript{142} Judge Francis Conrad disagreed with the premise that an assured creditor with a security interest in the assets of a surety received more than it would have in a hypothetical chapter 7 liquidation. There, a lender advanced funds to the debtor, and insiders of the debtor pledged their personal property as security for the loan, making the insiders nonrecourse sureties with contingent unsecured subrogation rights against the debtor.\textsuperscript{143} Although the debtor paid the assured creditor in full during the preference period, Judge Conrad, quite inexplicably, ruled that the trustee could not prevail under the hypothetical liquidation test because the assured creditor would recover fully in the bankruptcy. That full recovery was from non-debtor property was dismissed as a "flaccid argument."\textsuperscript{144} Judge Conrad pointed out that the Uniform Commercial Code defines "debtor" to include:

\begin{itemize}
  \item \textsuperscript{141} E.g., Coral Petroleum v. Banque Paribas-London, 797 F.2d 1351, 1357-58 (5th Cir. 1986).
  \item \textsuperscript{142} 165 B.R. 140 (Bankr. S.D.N.Y. 1994).
  \item \textsuperscript{143} The suretyship arises when a third party offers collateral for a loan to another. Harrison v. Brent Towing Co. (\textit{In re H & S Transp. Co.}), 939 F.2d 355, 360 (6th Cir. 1990); \textit{RESTATEMENT OF SURETYSHIP} § 2 (Tentative Draft No. 2 1993) ("The secondary obligor may, however, lend its property to the principal obligor so that the principal obligor may grant the security interest."). Judge Francis Conrad, however, denied this premise:
    
    We note merely that the loan documentation in evidence affords no basis for any claim by the officers against Debtor in the event Debtor had defaulted and NYNB had liquidated the officers' certificates of deposit. Debtor did not agree to indemnify the officers. The officers did not provide a guaranty, which would give rise to a subrogation claim. Rather, they merely put up the collateral.
  \item \textsuperscript{144} 165 B.R. at 144.
\end{itemize}
the person who owes payment . . . whether or not he owns or has rights in
the collateral . . . Where the debtor and the owner of the collateral are not
the same person, the term "debtor" means the owner of the collateral . . . .

According to Judge Conrad, this provision proved that the assured credi-
tor was in fact an oversecured creditor, thereby negating section 547(b)(5)
and saving the creditor from voidable preference liability. In other words,
because the Uniform Commercial Code refers to both the principal obli-
gor and the nonrecourse surety as "debtors," Judge Conrad believed that
the two persons were really one; that they bore the same name of
"debtor" justified their substantive consolidation.

146 For two similar cases, see Schwartz v. Pitman-Moore, Inc. (In re Schwartz), 54 B.R. 321,
325 (Bankr. W.D. Wis. 1985); Hargadon v. Cove State Bank (In re Jaggers), 48 B.R. 33 (Bankr.
W.D. Tex. 1985). In Schwartz, the debtor—improbably but successfully—claimed that the subsidi-
ary’s property was his own exempt property under Bankruptcy Code § 522. The debtor was then
permitted to maintain a voidable preference action in his own name under § 522(g), even though
§ 522(g) prohibits such personal use of voidable preference law when the debtor voluntarily conveyed
the property. Missing from this opinion is a theory explaining why money from the subsidiary is
property of the debtor, justifying the voidable preference recovery. One possible answer is that, in
effect, the debtor awarded himself a dividend from his corporation, making the payment debtor prop-
erty. The debtor then directed the payment to the creditor in violation of the voidable preference
statute. A similar theory will later be used to explain that, when a debtor arranges for a letter of
credit just before bankruptcy in exchange for collateral, the bank has received no transfer, but the
bank funds directed to the assured creditor are in reality debtor funds, thereby justifying an action
against the assured creditor as the initial transferee of debtor property. See infra notes 167-85 and
accompanying text.

In Jaggers, a subsidiary wrote a check to a creditor on a bank account that contained both
corporate funds and the debtor’s personal funds. The entire check was declared to be debtor property
on the basis:

When a debtor uses the funds of a third party to pay an obligation of the debtor the Court
must look to the source of the control over the disposition of the funds in order to deter-
mine whether a preference exists. If the debtor controls the disposition of the funds and
designates the creditor to whom the monies will be paid independent of the third party
whose funds are being used in partial payment of the debt, then the payments made by the
debtor to the creditor constitute a preferential transfer. Hence, if the funds are available for
payment to the creditors of the debtor generally the funds are an asset of the estate and
payment thereof constitutes a diminution of the estate.

48 B.R. at 36-37. This theory of debtor ownership must be sharply questioned. Admittedly, under
standard tracing rules, the debtor should be presumed to use only his funds first to pay a debt. But
thereafter corporate funds—non-debtor property—are being used. See Carlson, supra note 83
(describing the tracing rules when the debtor writes check on commingled accounts in voidable prefer-
ence cases). As to corporate funds, mere fiduciary control of funds should not, as Judge Bert Thomp-
son suggested, be viewed as establishing debtor ownership, for the purposes of the voidable preference
statute. Begier v. Internal Revenue Serv., 496 U.S. 53 (1990) (IRS was not liable for voidable prefer-
ence when payment came from trust held for the benefit of IRS).
Judge Conrad obviously overlooked the principle that two persons can have the same name without obliterating their separate personalities. As a result, he applied neither the hypothetical liquidation test nor the law of substantive consolidation properly.\footnote{147} Under the hypothetical liquidation test in section 547(b)(5), the payments received must hypothetically be returned to the debtor, the court must calculate a hypothetical chapter 7 liquidation dividend, and then we must compare that hypothetical dividend to the payment actually received. That some third party has pledged collateral that the assured creditor could reach outside of bankruptcy is irrelevant. Even if the assured creditor recovers from the collateral of the surety, the surety steps into the assured creditor's shoes and makes the same unsecured claim against the debtor that the assured creditor would have made. The suretyship right merely affects the identity of the creditor making the unsecured claim in the debtor's bankruptcy, not the amount of the bankruptcy dividend to which that claim is entitled.

The purpose of the hypothetical liquidation test is to punish creditors who deplete the bankrupt estate in violation of the duty to remain equal with like-ranked creditors. The assured creditor in \textit{Wedtech} violated this duty by accepting payment within the preference period. The payment consisted of assets that should have been shared with other creditors. Since the other creditors had no access to the third party property pledged to the assured creditor, this collateral was irrelevant to the hypothetical liquidation analysis.\footnote{148}

Instead, the theory should be either that the debtor was conveying property of a third party, or that the debtor had awarded himself a dividend from the subsidiary and had forwarded this "debtor property" to the creditor. The former theory defeats the voidable preference action, but the latter would uphold it by explaining how these payments were "debtor property."

These cases are like \textit{Wedtech}, in that there are undisclosed or defective theories explaining why property of a subsidiary should be deemed property of the debtor, for voidable preference purposes. In \textit{Wedtech}, security interests granted by third parties in non-debtor property before the preference period made debtor payments \textit{within} the preference period immune from attack. In \textit{Schwartz} and \textit{Jaggers}, the payments themselves seemed to be non-debtor property, pending some satisfactory explanation as to why these payments belonged to the debtor at the time they were made.\footnote{147} \textit{See} Union Sav. Bank v. Augie/Restivo Baking Co. (\textit{In re Augie/Restivo Baking Co.}), 860 F.2d 515, 520 (2d Cir. 1988) (prohibiting substantive consolidations when creditors are prejudiced in distributions).

\footnote{148} For a similar error of analysis, see Harry M. Fletcher, \textit{Preferences, Post-Petition Transfers, and Transactions Involving a Debtor's Downstream Affiliate}, 5 Bankr. Dev. J. 1, 22-23 (1987). Fletcher is a critic of the so-called "earmarking doctrine," which allows one unsecured creditor to refinance a pre-existing unsecured loan without rendering the paid creditor liable for having received a voidable preference. \textit{See infra} note 182. In particular, Fletcher complains of solvent corporate subsidiaries that voluntarily refinance the debtor shareholder's unsecured loans; such refinancing lowers the value of the subsidiary's equity shares, thereby impoverishing the debtor's estate.
On the other hand, Judge Conrad's opinion is perfectly correct if the insiders did not merely lend their collateral as sureties to the debtor. If their collateral constituted an equity investment in the debtor, then the property pledged to the assured creditor really was debtor property, and the assured creditor was indeed an oversecured creditor in the debtor's bankruptcy. But this conception is clearly not what Conrad had in mind, given that his opinion assumes the surety continued to own the collateral. 149

A more subtle error along these lines occurs in Krafsur v. Scurlock Permian Corp. (In re El Paso Refinery, L.P. v. Scurlock Permian Corp.). 150 In this case, a supplier with a purchase money security interest in the inventory supplied signed a "sharing" or subordination agreement with an unsecured creditor, whereby the secured party shared forty-five percent of all collateral with the secured party. The debtor surrendered cash proceeds to the secured party, of which the unsecured creditor had a forty-five percent interest. Judge Leif Clark ruled that, since forty-five percent of the proceeds had been assigned away, the supplier could keep fifty-five percent of the cash surrendered and must return forty-five percent to the trustee as a voidable preference.

In fact, the subordination agreement should have been viewed as a nonrecourse guaranty, with the secured claim as the surety's collateral. 151 In this sense, it was like the Wedtech case, in that an assured creditor received property already belonging to the surety. The subordination agreement, designed to benefit a designated unsecured creditor, was therefore improperly used to disencumber cash proceeds for the benefit of all the unsecured creditors of the debtor.

One earmarking case that draws Professor Fletcher's displeasure is Coral Petroleum Inc. v. Banque Paribas-London, 797 F.2d 1351, 1357-58 (5th Cir. 1986). Fletcher complains that, since the refinancing unsecured creditor supplied collateral to the unhappy unsecured creditor prior to the 90 day preference period, the payment to the unhappy creditor just prior to bankruptcy would be protected from avoidance by the hypothetical liquidation test of § 547(b)(5). This, Fletcher claims, is a mode of decision that would successfully protect the oversecured creditor in a manner that was superior to the disfavored earmarking doctrine. Yet this is precisely the same analytical error committed by Judge Conrad in the Wedtech case. Application of the hypothetical liquidation test clearly condemns such a payment, when a surety has supplied the collateral.

149 See Wedtech, 165 B.R. at 144.
D. Remedies

Suppose a surety's security interest is voidable under section 547(b). According to section 550(a)(1), the trustee may avoid a security interest itself, or, "if the court so orders, the value of such property." Furthermore, the trustee can recover value from either "the initial transferee or the entity for whose benefit the transfer was made." Can the trustee let the surety keep her security interest and instead recover value of the voidable security interest from the assured creditor? If so, the assured creditor might be forced to pay the value of the security interest to the debtor.

Typically, if the debtor pays the assured creditor, and if that payment had been recovered as a voidable preference, the suretyship agreement, formerly extinguished by the debtor's payment, revives, and the assured creditor can make the surety pay. It is less clear whether the suretyship obligation arises to indemnify the assured creditor when the assured creditor has to pay for the surety's security interest. For example, in *Kellogg v. Blue Quail Energy, Inc. (In re Compton Corp.)*, Judge Jerre Williams required payment by the assured creditor for the value of the surety's security interest and then denied the assured creditor any indemnity from the surety.

There is one circumstance in which the assured creditor might be unfairly hurt—when the trustee allows the surety's interest to stand, even after the surety received a voidable preference and fulfilled the suretyship obligation by paying the assured creditor. Though the surety has guaranteed the original assured claim, it may not have promised to hold the assured creditor harmless from voidable preference claims of the trustee. In such a case, the assured creditor clearly cannot recover the value of the security interest from the surety, and the surety becomes a fully secured creditor in the debtor's bankruptcy, even though its security interest

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163 Id. (emphasis added).
164 One should bear in mind that the surety is often an insider and, in chapter 11, often the person in charge of bringing voidable preference actions in the first place.
166 831 F.2d 586 (5th Cir. 1987), modified, 835 F.2d 584 (1988) (per curiam).
167 Id. at 591. Of course, it is possible—and advisable—for the suretyship agreement itself to contain a clause holding the assured lender harmless for any voidable preference recovery by the trustee. Baker, *supra* note 63, at 147. If such a clause exists, the assured creditor is relieved of some financial risk of the theory just described.
should have been a voidable preference.

Now, according to the Restatement of Suretyship, the assured creditor can expropriate any security interest granted to the surety. Under this rule, the surety obtains the security interest that the trustee has deliberately allowed to survive. But this security interest, by definition, secures the suretyship claim against the debtor. It does not secure a right to an indemnity for a voidable preference judgment levied against the assured creditor. Restitutionary intuition strongly suggests that, if the assured creditor is made to pay for the surety's voidable preference, the surety should suffer—not the assured creditor. At confusing moments such as these, courts have been known to declare the surety's secured claim against the debtor to be encumbered by an equitable lien in favor of the assured creditor.

If, however, the Restatement of Suretyship is not followed, or if restitutionary intuitions become lost, confused, or drowned in the plain meaning of the Bankruptcy Code, the assured creditor must pay a money judgment equal to the value of the surety's security interest, and cannot recoup this amount back from the surety.

It is to be hoped that a bankruptcy court, in exercise of its discretion under section 550(a)(1), will limit the trustee to avoidance of the security interest rather than allowing the trustee to pursue the assured creditor for the value of the standing security interest. Indeed, section 550(a)(1) provides that the trustee may have the value of the preference only "if the court so orders." Courts could use this invitation to judicial supervision to prevent any abuses. Nevertheless, it must count as a weakness in the Bankruptcy Code that it depends on unregulated judicial discretion to restore decorum to its unruly governance of debtor-creditor relations.

This good advice was ignored in Taunt v. Fidelity Bank of Michigan (In re Royal Golf Products Corp.), where an insider surety forgot to

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1 Restatement of Suretyship § 29 (Tentative Draft No. 2 1993).
4 11 U.S.C. § 550(a)(1) (1988). The Bankruptcy Act had vested this discretion in the trustee, not the courts, and, at least after 1938, required that "value" could be had in lieu of the thing transferred only if the debtor converted the original transfer to her own use. See generally Countryman, supra note 160, at 449-55, 467 (describing the history of trustee recoveries prior to the enactment of the Bankruptcy Code).
perfect his security interest in assets of the debtor. Because of this failure to perfect, the assured creditor received benefit just before the bankruptcy petition. Before the bankruptcy petition, the insider paid the debtor's obligation in full. Judge Nathaniel Jones ruled that the assured creditor was liable for the value of the security interest issued to the insider.

Judge Jones' holding, although consistent with the literal words of section 550(a)(1), was most unfair from the higher perspective of natural law. If the trustee can recover the value of the voidable preference from the assured creditor, she cannot recover a second time from the surety, as section 550(d) prevents double recoveries for the same preference. This implies that the insider becomes a secured party in the debtor's bankruptcy as a result of the payment made to the assured creditor, by virtue of its unperfected security interest. Meanwhile, the assured creditor had to pay the value of the insider's security interest without necessarily being able to collect again from the surety, who after all had already paid up on its suretyship obligation.

II. DEFENSES TO THE PRIMA FACIE CASE

A. Defenses Assertable by Beneficiaries

A difficult issue in tripartite cases is the extent to which non-transferee beneficiaries liable under section 547(b) may assert defenses under section 547(c). Most of these defenses, by their terms, defend only transfers—not the benefit radiating from transfers.

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163 In this case, the lender had no security from the debtor, but the insider had arranged for a letter of credit, secured by the insider's stock portfolio. When the debtor defaulted, the insider requested the right to pay the lender directly, so that the stock portfolio would not be disturbed. Id. at 697. The insider paid and hoped to recoup from the debtor under their security agreement. The collateral consisted of inventory plus a patent. The surety's financing statement perfected a security interest in the inventory, but not the patent. Earlier obligations, however, had fully encumbered the inventory so that, when the surety paid the assured creditor, the advance was against the patent only.


165 Royal Golf, 908 F.2d at 93. Actually, he characterized the judgment as avoiding the payment by the insider to the extent of the value of the security interest. Properly speaking, however, the payment was not being recovered. Rather, it was the value of the security interest issued to the debtor which the debtor sought. Royal Golf, 79 B.R. at 699 (“[I]n the present case, it must be held that Royal Golf controlled the disposition of the [insider's] funds to the extent of the security interest given to [the insider] to secure the loan.”).


167 An exception to this rule is found in 11 U.S.C. § 547(c)(4) (1988), which refers to transfers "for the benefit" of a creditor. These beneficiaries will have a defense under § 547(c)(4) if they give new value to or on behalf of the debtor.
In this regard, it is necessary to jump ahead to disclose that a logical predicate of *Deprizio* was that “benefits” under section 547(b)(2) were not “transfers.” Every case following *Deprizio* affirmed this proposition, and every case that disparaged *Deprizio*’s reasoning did so on the premise that benefits themselves are transfers. This is the so-called “two transfer” theory, upon which *Deprizio* was supposed to have risen or fallen. Whether the “two transfer” theory has intrinsic merit will be assessed later.168

For the moment, it may be noted that the validity of the “two transfer” theory has important effects with regard to the defenses in section 547(c). If a benefit is a transfer, then the beneficiary’s section 547(c) defense must distinguish the benefit from the transfer that gave rise to the benefit.169 For example, suppose a senior secured party obtains payment in the ordinary course of business and utilizes this as a defense under section 547(c)(2).170 If the junior secured party’s “benefit” is a transfer unto itself, then the junior secured party cannot assert the section 547(c)(2) defense for the benefit, because section 547(c)(2) defends only “payments”—not the supposedly separate transfer of which the benefit of the payment consists. But if the benefit is not a separate transfer, then the beneficiary may invoke section 547(c)(2) to show that the one and only underlying transfer was in the ordinary course and hence not voidable.171

In short, if the “two transfer” theory is denied, then beneficiaries have standing to assert defenses that refer to the initial transfer. If upheld, the “two transfer” theory destroys many of the defenses the beneficiaries would like to assert.

One of the principal cases following the “two transfer” theory is *Kellogg v. Blue Quail Energy, Inc. (In re Compton Corp.).*172 in which the surety; a bank, issued a letter of credit to an unsecured supplier on antecedent debt. In exchange, the bank received a security interest in the debtor’s assets. In our earlier discussion of that case, we saw that the bank

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168 Newly amended § 550(c) says nothing about the merits of the “two transfer” theory either, so the validity of the doctrine is still open to question.
170 According to § 547(c)(2):

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 of financial affairs of the debtor and the transferee; and (C) made according to ordinary business terms . . . .

Id. § 547(c)(2).
172 831 F.2d 586 (5th Cir. 1987), modified, 835 F.2d 584 (1988) (per curiam).
escaped liability on illegitimate grounds. Properly analyzed, the bank had *prima facie* liability under section 547(b), but it also qualified for the defense under section 547(c)(1). According to section 547(c)(1), the trustee may not avoid the transfer:

- 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... 

That is, the bank and the debtor intended to exchange a security interest on the debtor’s assets for the new value the bank would supply. Therefore, by use of section 547(c)(1), it is possible to confirm the result that Judge Williams reached, but on much different grounds.

Now, whether one follows Judge Williams’ defective theory, based on massacring the state law of attachment, or the more sound theory that relies on the section 547(c)(1) defense, it would appear to the casual observer that the bank was the initial transferee of another’s voidable preference. As such, it might have succumbed to *Deprizio*-style liability. But Judge Jerre Williams held otherwise. According to Williams, the benefit to the assured creditor was itself a transfer, separate and apart from the security interest the bank received. Because this was so, the bank was not the “initial transferee” of the supplier’s voidable preference but was instead the initial transferee of an entirely different transfer.

This holding in favor of two transfers is clearly correct—on the facts of the case before Judge Williams. Furthermore, this holding is entirely consistent with *Deprizio* because it does not rely on the general proposition that “benefits” under section 547(b)(2) are “transfers.”

To see why, it is necessary to examine the bank’s section 547(c)(1) defense a little more closely. Under section 547(c)(1), the bank intended

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173 Judge Jerre Williams had proclaimed that the bank’s security interest dated back to the time of the security agreement, even though the bank had discretion to extend or refuse credit. Such a conclusion misconceives the law of loan commitments under Article 9 of the U.C.C. Instead, the security interest to the bank was created only when the bank decided to issue the letter of credit. As a result, the security interest was for or on account of antecedent debt—the amount owed to the supplier. Because the supplier’s antecedent debt counted for both the supplier and the bank, the bankruptcy trustee could make out the *prima facie* case against both creditors—the bank and the supplier. See *supra* notes 117-28 and accompanying text.


175 831 F.2d at 591-95.
for the creation of its security interest to be contemporaneous with the bank’s tender of new value—the proceeds of the letter of credit. But section 547(c)(1) requires that the new value be given “to the debtor.” How can it be said that the bank paid new value when the bank forwarded the funds directly to the assured creditor? This objection can be answered by observing that paying another creditor at the behest of the debtor is the same as giving the new value directly to the debtor, who might then have forwarded it to the assured creditor. The Bankruptcy Code supports this characterization, defining “transfer” as, “every mode, direct or indirect . . . of disposing of or parting with property . . . .”176 “Indirect transfer” can only be interpreted to mean that the bank’s extension of credit to the supplier was indirect property of the debtor. Therefore, the bank in Compton was fully entitled to invoke the section 547(c)(1) defense (to the extent of new value actually given).177 This theory saves the bank when the suretyship contract and the security interest are contemporaneous.178

The question arises, though, why the supplier in Compton was not also entitled to the section 547(c)(1) defense. Suppose we say that the supplier received a “benefit” from the security interest. The supplier’s benefit was contemporaneous with the new value that the bank admittedly sup-

177 Compton, 831 F.2d at 586. It will be noted that § 547(c)(1)(A) requires a gift of new value (by anyone) to the debtor directly. 11 U.S.C. § 547(c)(1)(A) (1988). In contrast, § 547(c)(4) flips these requirements by indicating that only the creditor who is the voidable preference defendant can give the new value, but the new value need not be given directly to the debtor. Rather, it suffices that the new value was given to a third party “for the benefit of the debtor.” Id. § 547(c)(4). Nevertheless, it is possible to say that the supplier gave new value to the debtor, with the debtor then directing that this new value be given to one of the debtor’s unsecured creditors.

This implies, of course, that two transfers of debtor property occurred. First, the debtor transferred a security interest to the issuing bank. Second, the issuing bank gave an equivalent amount of value back to the debtor who designated the bank as its agent to transfer this new value to the unsecured creditor. This is precisely what Judge Williams held in order to explain why the bank did not have Deprizio liability for being the recipient of the security interest which enabled the unsecured supplier to be paid.

178 It does so without falsely treating the surety’s contingent claim as an antecedent debt which the debtor “owes.” Earlier, I suggested that, since the subrogation claim of the surety is entirely contingent before the surety pays the assured creditor, the debtor does not “owe” the surety anything. See supra note 108 and accompanying text. Nevertheless, the debtor “owes” the assured creditor on an antecedent debt and is making transfers to the surety. The transfer to the surety on account of an antecedent debt owed to the assured creditor established the prima facie liability of both the assured creditor (as the entity benefited) and the bank (as transferee on an antecedent debt). This allowed us to assert the general proposition in bipartite cases that mere commitments to lend are not antecedent debts until funds are actually advanced. The exclusion of commitments to lend from the concept of antecedent debt in § 547(b)(2) is vitally important for secured transactions under Article 9. See generally Carlson, supra note 11.
plied. The section 547(c)(1) defense does not require the supplier to pro-
vide the new value.179 A third party may supply the new value, so long as it
was intended by the debtor and the creditor benefited by the transfer.
Why should the supplier be deprived of the same defense that the bank
utilized?

The answer is that the supplier can indeed assert the defense, but
only with regard to the *benefit* obtained from the security interest. Even if
the supplier had the *benefit* of the bank's security interest, it received an
entirely different transfer as well—the proceeds of the letter of credit.
Recall that the bank's own section 547(c)(1) defense required us to believe
that new value was given "to the debtor," who then (by act of the bank)
gave the debtor's property to the supplier.180 This means that separate
and apart from the bank's security interest, the supplier is being sued for
an entirely different transfer of debtor property—the receipt of dollars
supplied by the bank. As to this separate transfer, the supplier could have
no defense. No new value was supplied in exchange for this cash. Thus,
the security interest of the bank enjoys the section 547(c)(1) defense,
which may be asserted by initial transferee and beneficiary alike. But, in
fact, there were two transfers in *Compton*. Only the supplier qualified as
the initial transferee of the second transfer—the cash proceeds of the letter
of credit. This second transfer engenders no defense under section
547(c)(1). Because the bank was not the beneficiary (indeed it was the
source of the funds),181 the bank can have no *Deprizio* liability for what

179 Here again is the text of § 547(c)(1):

(c) The trustee may not avoid under this section a transfer—(1) to the extent that such
transfer was—(A) intended by the debtor and the creditor . . . 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; . . . .


180 In this regard, note that the Bankruptcy Code's definition of "transfer" includes the concept
of the "indirect" transfer, thereby supporting the argument in the text. 11 U.S.C. § 101(54) (Supp. V
1993).

181 The bank will have issued the letter of credit in exchange for a fee. Is this a "benefit"
radiating from the supplier's transfer? The answer must be yes. In addition, it must be a benefit
received on antecedent debt, because, as was said earlier, a surety's benefit can be on an antecedent
debt owed to another. See supra text accompanying notes 114-15. The "nexus" requirement, how-
ever, prevents this benefit from drawing the bank into the maelstrom of the supplier's preference
liability. According to the nexus requirement, the supplier's claim against the debtor must enjoy a
unity with the bank's claim, such that payment or collateralization of one claim implies payment or
collateralization of the other. See supra text accompanying notes 45-63. Here, the debtor's payment
to the suppliers did not "pay" the bank. The opposite is true. The payment *created* the debtor's liability
to the bank for which the bank received a separate security interest.
the supplier received.\textsuperscript{182}

It may be emphasized that Judge Williams’ “two transfer” theory from \textit{Compton} does not put him in conflict with the \textit{Deprizio} holding.\textsuperscript{183}

\textsuperscript{182} By way of refinement, suppose the letter of credit promised the supplier $100, but the bank's security interest in the debtor's assets was worth only $10. This results in the bank becoming an undersecured creditor. On the theory just presented, the supplier is liable for the proceeds of the letter of credit ($100) which we have deemed to be property of the debtor.

The supplier should be liable only for $10—the amount the security interest diminished the debtor’s estate. Kellogg v. Blue Quail Energy, Inc. (\textit{In re Compton Corp.}), 835 F.2d 584 (5th Cir. 1988) (per curiam) (trustee has a remedy against the assured creditor for what the debtor transferred to the surety); Mandrosa v. Peoples Banking Co. (\textit{In re Hartley}), 825 F.2d 1067 (6th Cir. 1987) (same). Yet the “two transfer” theory suggests that the remedy should be based upon the property that the bank, on behalf of the debtor, transfers to the assured creditor. How can we say that the remedy should be for $10 when the bank conveyed $100 to the assured creditor?

One way to achieve this result, consistent with the “two transfer” theory of Judge Williams, is by means of the “earmarking doctrine.” According to this doctrine, the proceeds of an unsecured loan obtained for the purpose of refinancing some other unsecured claim are not to be deemed property of the debtor, even if the debtor receives the initial advance and later forwards the proceeds to the intended beneficiary. \textit{E.g.}, Hansen v. MacDonald Meat Co. (\textit{In re Kemp Pac. Fisheries, Inc.}), 16 F.3d 313, 316 (9th Cir. 1994) (per curiam). Rather, these loan proceeds are considered property of the second lender. In short, the earmarking doctrine is the mirror opposite of the doctrine claiming that the loan proceeds are indeed property of the estate when the debtor grants a security interest in exchange. Mandross v. Peoples Banking Co. (\textit{In re Hartley}), 825 F.2d 1067 (6th Cir. 1987) (applying the earmarking doctrine only to the unsecured deficit claim and holding the recipient of borrowed funds for the value of the security interest granted to the refinancing lender).

Putting the “two transfer” theory together with the earmarking doctrine, of the $100 supplied by the bank under the letter of credit, $10 are property of the debtor, which is transferred to the supplier. The remaining $90 are property of the bank only, under the earmarking doctrine. Thus, in American Bank v. Leasing Serv. Corp. (\textit{In re Air Conditioning, Inc., of Stuart}), 845 F.2d 293 (11th Cir.), cert. denied, 488 U.S. 993 (1988), the debtor had pledged a certificate of deposit as collateral for a letter of credit on antecedent debt. Judge Robert S. Vance did not permit avoidance of the security interest against the bank. Rather Judge Vance wanted the trustee to recover from the beneficiary of the letter of credit. The recovery, however, was described as “payment made pursuant to the letter of credit,” and also as proceeds of the certificate of deposit. \textit{Id.} at 294-95. These two remarks are reconciled by what has just been suggested. The proceeds of the letter of credit were received (by the debtor) in exchange for the security interest. These proceeds—property of the debtor—were then transferred to the assured creditor on antecedent debt and were recoverable accordingly.

In criticizing the earmarking doctrine, Professor Harry Fletcher points out that “the oft-repeated assertion that earmarking prevents the transferred property from becoming property of the estate represents a misguided attempt to create a statutory basis for the judge-made earmarking doctrine, and should be rejected.” Fletcher, \textit{supra} note 149. This is no doubt a valid criticism. Perhaps the earmarking doctrine—and any chance for refinancing unsecured claims—should be viewed as contrary to the statutory language of § 547. But it still remains the case that, at least insofar as the earmarking doctrine is concerned, secured loan proceeds directed to a third party are in fact property of the estate, which the debtor separately conveys to the beneficiary of the letter of credit. This concession proves that Judge Williams’ “two transfer” theory was essentially correct as applied to the facts of the \textit{Compton} case.

\textsuperscript{183} This is not how Judge Williams viewed the matter. In his opinion, he asserted that benefits are always separate transfers. \textit{Compton}, 831 F.2d at 591-93. This broad language indeed conflicts
In *Deprizio*, Judge Easterbrook held that there was only one transfer of debtor property, and one benefit emanating from that transfer. But, in *Deprizio*, the facts were different; a debtor paid a creditor and the insider surety was benefited. Only one transfer occurred in *Deprizio*. Since no new value was forwarded to the debtor, there was no occasion to find that two transfers of the debtor's property occurred. It is possible, then, to affirm the reasoning in *Compton* and still agree that, generally, benefits are not transfers. If benefits are not transfers, it becomes easy to reconcile the liability of beneficiaries under section 547(b), and their access to defenses under section 547(c), which generally immunize only transfers, not benefits from transfers. Whenever the benefit is not itself an indirect transfer of debtor property, the beneficiary has standing to show that because the transfer is not voidable, neither is the benefit. Liability for the benefit and for the transfer will, therefore, rise and fall together.

**B. New Value Contemporaneously Exchanged**

If the assured creditor is unsecured but the surety is fully secured, and if the assured creditor receives transfers directly from the debtor within the preference period, the trustee can make out the full *prima facie* case against the assured creditor. The assured creditor, however, may assert the defense set forth in section 547(c)(1). As we have seen, section 547(c)(1) requires that new value be given to the debtor, but it does not specify who must do the giving. Therefore, if the assured creditor receives the voidable preference and the surety gives back the new value, the assured creditor may assert the defense.

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with Judge Easterbrook's opinion in *Deprizio*.

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184 Levit v. Ingersoll Rand Fin. Corp., 874 F.2d 1186, 1196 (7th Cir. 1989).

185 Thus, in *T.B. Westex Foods, Inc.* v. Federal Deposit Ins. Corp. (*In re T.B. Westex Foods, Inc.*), 950 F.2d 1187 (5th Cir. 1992), Judge William Garwood found that, in *Compton*, there really were two transfers, while in *Westex* (involving a collection from a bankrupt garnishee by a garnishor), there was but one transfer, for which the garnishor had *Deprizio* liability. *T.B. Westex*, 950 F.2d at 1194. Garwood also found that, under the facts of *Deprizio*, there are two transfers. *Id.* Perhaps he felt the need to do so in order to conform his opinion with the earlier decision in *Compton*. If so, such deference was unnecessary. It is fully possible to reconcile *Compton* with *Deprizio*.


When the surety is fully secured and the assured creditor receives transfers from the debtor, the debtor receives new value. Every dollar paid to the assured creditor reduces the surety's security interest, thereby enriching the debtor.\footnote{188} For example, in \textit{Gulf Oil Corp. v. Fuel Oil Supply \& Terminaling, Inc. (In re Fuel Oil Supply \& Terminaling, Inc.)},\footnote{189} two banks issued letters of credit to the debtor's supplier in exchange for a security interest in collateral ample enough to keep the banks fully secured. The supplier sent gasoline to the debtor, thereby becoming an unsecured creditor of the debtor. Instead of calling in the letter of credit, the creditor accepted payment directly from the debtor. The creditor received a voidable preference under section 547(b), but it had a full defense under section 547(c)(1).\footnote{190} Every dollar the debtor paid released a dollar of collateral earlier pledged to the sureties.

Courts occasionally miss the section 547(c)(1) defense in cases where the surety is fully secured and the assured creditor is unsecured.\footnote{191} Thus, in \textit{Security First National Bank v. Brunson (In re Coutee)},\footnote{192} a law firm guaranteed an unsecured loan to a client. The law firm was a fully secured creditor for the amount loaned and also for its contingency fee. As collateral, the law firm could claim the proceeds of a personal injury judgment in favor of the client. The client won a large judgment, the loser paid the client's law firm, the law firm paid the lender, and the law firm returned the surplus to the client. The plaintiff soon filed for bankruptcy, unsecured revolving credit. The debtor drew down unsecured credit to pay interest on the secured claim. Judge Lavien ruled that a § 547(c)(1) defense canceled the voidable preference liability of the undersecured parties. \textit{Id.} at 30. That is, the revolving credit was substantially contemporaneous with the payment of interest. The reason this defense was appropriate was because it showed that, at the time the insider received a benefit, the debtor received new value from the assured creditors. \textit{Id.} Accordingly, the new value supplied by another was used to defend the insider's own § 547(b) liability. Because the insider had no § 547(b) liability, the undersecured creditors could have \textit{no} Deprizio liability.

Later, Judge Lavien seems to have changed his mind and ruled that the undersecured parties were liable after all. From this unreported \textit{changement de coeur}, the undersecured parties appealed. In \textit{Travelers Ins. Co. v. Cambridge Meridian Group, Inc. (In re Erin Food Servs., Inc.)}, 980 F.2d 792 (1st Cir. 1992), Judge Conrad Cyr found that no benefit to insiders existed, thereby defeating any \textit{prima facie} case and obviating any need to consider the status of any defense under § 547(c).\footnote{193} In contrast, the mere disappearance of an unsecured subrogation claim cannot count as new value, since the disappearance in no way enriches the other general creditors of the debtor. \textit{LaRose v. Crosby \& Son Towing, Inc. (In re Dick Henley, Inc.)}, 38 B.R. 210, 213 (Bankr. M.D. La. 1984).\footnote{194} 837 F.2d 224 (5th Cir. 1988).\footnote{195} \textit{Id.}

\footnote{196} 837 F.2d 224 (5th Cir. 1988).


\footnote{198} 984 F.2d 138 (5th Cir. 1993) (per curiam).
and the bankruptcy trustee sued the lender to recover the payment as a voidable preference.

The lender first argued that it was not the initial transferee—the law firm was, as the payment came from the proceeds of the judgment. If this argument had worked, the lender would have been a transferee of a transferee, entitled to the defense described by section 550(b).\textsuperscript{103} The court held, however, that the law firm was just a transparent conduit.\textsuperscript{104} The court explained, "[A] party that receives a transfer directly from the debtor will not be considered the initial transferee unless that party gains actual dominion or control over the funds."\textsuperscript{105} "And 'dominion' meant the freedom 'to invest the whole [amount] in lottery tickets.'"\textsuperscript{106} Since the law firm had no such freedom to play the lottery, the law firm was not the initial transferee—the bank was.

All this was quite beside the point. The lender had a section 547(c)(1) defense, because every dollar it received reduced the surety's security interest against the debtor's property.\textsuperscript{107} This constituted new value extended (by the surety) contemporaneously with the payment to the lender.

But more fundamentally, the Fifth Circuit incorrectly decided the case because the trustee could not properly plead a \textit{prima facie} case against the bank. In \textit{Brunson}, as payment the bank received the surety's cash collateral.\textsuperscript{108} It is a prime feature of the hypothetical liquidation test that the surrender of cash collateral can never be preferential, so long as the security interest on the cash was itself not voidable.\textsuperscript{109} Therefore, no transfer to the bank of cash proceeds of a valid security interest could

\textsuperscript{103} According to 11 U.S.C. § 550(b) (1988):

\[(b) \text{The trustee may not recover under section (a)(2) of this section from— (1) the initial transferee of such transfer or the entity for whose benefit such transfer was made; (2) any immediate or mediate good faith transferee under subsection (a) of this section.}\]

\textit{Id.} The lender argued that it was a transferee of a transferee under § 550(a)(2) and hence entitled to the defense in § 550(b).

\textsuperscript{104} \textit{Brunson}, 984 F.2d at 144.

\textsuperscript{105} \textit{Id.}

\textsuperscript{106} \textit{Id.} at 141 (citing Bonded Fin. Servs., Inc. v. European Amer. Bank, 838 F.2d 890, 894 (7th Cir. 1988)). Actually, few fiduciaries have the right to use trust funds to play the lottery. Judge Easterbrook's rhetoric should not be taken to mean that those with a fiduciary duty to invest funds wisely are never initial transferees under § 550(a)(1). Those schooled in law and economics are simply enamored with the lottery as a metaphor for economic risk taking. This is odd because the lottery is economically irrational to play—strictly a sucker bet.

\textsuperscript{107} But see Kleckner v. Russell (\textit{In re Kleckner}), 81 B.R. 464, 467 (Bankr. N.D. Ill. 1988) (under Illinois law, attorney's liens unperfected until court acknowledges its existence).

\textsuperscript{108} \textit{Brunson}, 984 F.2d at 140.

\textsuperscript{109} See Carlson, \textit{supra} note 11.
possibly meet the hypothetical liquidation test of section 547(b)(5). A deceptively difficult case where the court missed a section 547(c)(1) defense is Kepler v. Aetna Finance Co. (In re Ausman Jewelers, Inc.), where a debtor sold jewelry to customers on open account. The debtor sold the account to a secured party for cash. Later, two customers returned the jewelry, for undisclosed reasons, and the debtor agreed to refund the price. The customers owed the secured party, however, not the debtor. The debtor therefore promised to pay the account owed to the secured party. Later, the debtor forwarded unencumbered dollars to the secured party and then filed for bankruptcy. The bankruptcy payment trustee claimed that the payment to the secured party was a voidable preference, of which the secured party was the initial transferee.

Judge Robert Martin agreed that the secured party had received a voidable preference. Oddly, he did not hold that the secured party was a creditor of the debtor. Rather, the secured party was a creditor of an account debtor. Therefore, Judge Martin ruled that the payment of the account was for the benefit of the customers. The secured party, however, was the initial transferee of the customers’ voidable preference and, under section 550(a)(1), it had Deprizio liability for it.

In fact, the returned jewelry was collateral. Therefore, it is possible that a section 547(c)(1) defense existed. It is impossible to judge from Judge Martin’s opinion what shape this defense might take. We need to know why the customers returned the jewelry.

For example, let us suppose that the jewelry was being returned because of latent defects. In such a case, the customer could revoke acceptance, and no sales contract will have been formed. If no sales contract existed, the customer owed the debtor nothing, and the debtor had no account to sell to the secured party. If not, it is possible that the secured

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200 Crucial to the preceding analysis is the release of the surety’s security interest. Mere reduction of an unsecured suretyship claim (because the assured creditor was paid) could not by itself be considered “new value” because suretyship simply affects the identity of the creditor claiming against the bankrupt estate. Suretyship never aids the debtor’s balance sheet. See Nordberg v. Arab Banking Corp. (In re Chase & Sanborn Corp.), 904 F.2d 588, 596 (11th Cir. 1990); Simon v. Engineered Protection Sys. (In re Hatfield Elec. Co.), 91 B.R. 782, 785 (Bankr. N.D. Ohio 1988).

201 177 B.R. 282 (Bankr. W.D. Wis. 1995).

202 Id. at 285 n.3.

203 U.C.C. § 2-608(1) provides:

The buyer may revoke his acceptance of a . . . unit whose non-conformity substantially impairs its value to him if he has accepted it . . .

(b) without discovery of such non-conformity if his acceptance was reasonably induced either by the difficulty of discovery before acceptance or by the seller’s assurances.

party was entitled to a refund from the debtor, because it paid for an account that did not exist. Such refunds or chargebacks are often expressly provided for in security agreements. If a right to a refund existed, then contrary to Judge Martin’s opinion, the secured party was a creditor of the debtor. Given a right to a refund, the returned jewelry would have been collateral for the secured party. According to Uniform Commercial Code section 9-306(5):

If a sale of goods results in an account . . . which is transferred by the seller to a secured party, and if the goods are returned to or are repossessed by the seller or the secured party, the following rules determine priorities:

(a) If the goods were collateral at the time of sale, for an indebtedness of the seller which is still unpaid, the original security interest attaches again to the goods and continues as a perfected security interest if it was perfected at the time when the goods were sold . . .

(c) An unpaid transferee of the account has a security interest in the goods against the transferor. Such security interest is subordinate to a security interest asserted under paragraph (a).

(d) A security interest of an unpaid transferee asserted under paragraph . . . (c) must be perfected for protection against creditors of the transferor and purchasers of the returned or repossessed goods.204

We do not know from Judge Martin’s opinion whether the secured party was also an inventory financier or merely the buyer of accounts. If the secured party financed inventory, as well as bought accounts, then section 9-306(5)(a) applies, and provides the secured party with a perfected security interest in the jewels. If the amount of the refund is less than the value of the jewels—unlikely, where the jewels were defective—then the payment is voidable. All payments to undersecured creditors are voidable under Bankruptcy Code section 547(b)—until the payment exceeds the unsecured deficit. After that point, the payment releases the secured party’s security interest in the returned jewels, and to this extent the secured party might have a section 547(c)(1) defense.205

Suppose the secured party did not finance inventory, but rather only bought the accounts in question. In this case, section 9-306(5)(c) applies. The application of subsection (c) poses some problems for the secured party’s position. If some other undersecured inventory financier existed, that other secured party would have priority to the returned jewelry, in

205 See Carlson, supra note 11.
which case the buyer of the account may have had a security interest in
the return that was too deeply subordinated to do much good. Or, if the
inventory financier did not exist or was oversecured, the secured party
could claim the returned jewels as proceeds of a perfected security interest
in the accounts under section 9-306(5)(c), but, unless the financing state­
ment pertaining to the accounts referred to a proceeds security interest in
returned goods, the secured party’s perfection would lapse ten days after
the return. Since the return was in December 1991 (perhaps after
Christmas), and since the debtor paid the secured party in March, perfec­
tion may have lapsed. Lapse of perfection is a difficult voidable preference
issue. The usual reaction to it is that lapsed perfection renders the security
interest voidable under section 547(b). If so, the release of a voidable
unperfected security interest cannot constitute new value under section
547(c)(1).

These are the facts when the customers returned defective goods after
revoking acceptance. If the goods conformed to the contract, then the cus­
tomers were merely selling the goods back to the debtor. As the secured
party was not a party to this resale, the customer still owes the secured
party on the account. Meanwhile, section 9-306(5) still applies, so that
the jewels are collateral of the secured party. In effect, the customers and
the debtor have agreed that the secured party is a third party beneficiary
of the debtor’s obligation to pay. This makes the secured party a creditor
of the debtor, contrary to what Judge Martin ruled, and the jewelry is
collateral for this obligation to pay. Such a principle establishes the possi­
bility of a section 547(c)(1) defense, or perhaps even a defeat of the
prima facie voidable preference, if the value of the jewelry exceeds the debtor’s
obligation to pay the secured party.

For these reasons, it is unlikely that section 547(c)(1) defenses were
dismissed.

C. New Value Given Back

LaRose v. Crosby & Son Towing, Inc. (In re Dick Henley, Inc.). is a case in which a court wrongly applied section 547(c)(1). There, a
contractor paid a subcontractor shortly before bankruptcy. The subcon­
tractor held a statutory lien on a third party’s real property for services
and materials bestowed on that property. That made the third party a

207 See Carlson, supra note 11.
nonrecourse surety to the contractor. As surety, the real estate owner had a right over against the debtor, but this right was entirely unsecured. Judge Wesley Steen ruled that every dollar paid to the subcontractor released a statutory lien the debtor enjoyed against the surety and that this constituted a defense under section 547(c)(1) to the contractor's voidable preference liability.\textsuperscript{209}

The fault in Judge Steen's opinion lies in the fact that the debtor never received any new value. Only the surety did.\textsuperscript{210} Meanwhile, the payments depleted the debtor's estate to the prejudice of the debtor's unsecured creditors. Therefore, the payments should have been ruled voidable preferences.\textsuperscript{211}

Far from establishing the subcontractor's section 547(c)(1) defense, the reduction of the statutory liens against the third party's property had the opposite effect. It proved that the third party itself had received the benefit of transfers to the subcontractor, and therefore the third party had its own voidable preference liability.

If, however, the same subcontractor were to provide additional services to the debtor, the third party would have had a defense under section 547(c)(4) because the third party would have given the debtor new value. Specifically, the new value is the further encumbrance of the real estate. The new value would allow the debtor to generate a bigger account receivable (from the same third party), thereby enriching the debtor's estate.

This was the holding in \textit{Harrison v. Brent Towing Co. (In re H & S Transportation Co.)},\textsuperscript{212} where fuel suppliers of a debtor obtained maritime liens on a towboat every time the boat used fuel. The towboat, however, was not debtor property. Rather, the owner hired the debtor to run the towboat, meaning that the owner had become a nonrecourse surety for the supplier's unsecured claim against the debtor. The maritime lien could not, of course, mean that the supplier was oversecured in the debtor's bankruptcy. The surety was unsecured in that bankruptcy. Therefore,

\textsuperscript{209} \textit{Id.} at 212-14.

\textsuperscript{210} Judge Steen's answer to this argument was that § 547(a)(2)'s definition of new value included "release by a transferee of property previously transferred to such transferee in a transaction that is neither void nor voidable. . . ." 11 U.S.C. § 547(a)(2) (1988). The release of the lien caused release of the subrogation claim and hence the release was (indirectly) to the debtor. 38 B.R. at 215.


\textsuperscript{212} 939 F.2d 355 (6th Cir. 1991).
payments by the debtor for fuel within the ninety day preference period were for the benefit of the towboat owner and hence *prima facie* voidable preferences. Every such payment served to disencumber collateral owned by the surety. On this theory, the trustee tried to recover the value of payments to the assured creditor from the surety directly.

The supplier, however, had advanced new unsecured credit to the debtor after having been paid, creating yet new liens on the surety’s towboat. According to Judge Richard Suhrheinrich, this gave rise to a defense under section 547(c)(4). That is, the debtor received oil from the suppliers, and the towboat sustained a lien for the supplies. The oil was the new value, and it was produced by the surety’s alienation of the towboat in favor of the supplier. This new value defended the earlier preferences that had benefited the nonrecourse surety.

In *H & S*, the debtor received new value in the form of oil shipments in exchange for the debtor’s unsecured obligation to pay. The trustee chose to pursue the surety as the beneficiary of these transfers, but the surety could assert the new oil as a defense because the surety’s collateral to the supplier was likewise new value given “for the benefit of the debtor.” Suppose now that the trustee tries to pursue the assured creditor for receiving payments on antecedent debt. Given the fact that the new value—additional oil—has already been used as a defense by the supplier, can the assured creditor use that same new value defense a second time to defend against this new voidable preference theory?

Oddly, the answer is yes. Nothing in section 547(c)(4) prevents the same new value defense over and over again. As applied to *H & S*, this seems appropriate. Why should the supplier who actually supplied the oil be deprived of this defense just because the surety has already used the same oil to defend against the trustee’s voidable preference claim? In other situations, though, the repetitive use of a single dose of new value to defend against multiple voidable preference suits is deeply disturbing. In theory, where a creditor has received eight units of preference on eight different occasions and then gives back one unit of new value, that creditor could use the one unit of new value as a defense in each of the eight voidable preference actions. This defect is convenient in tripartite cases such as *H & S*, but quite upsetting in ordinary bipartite cases which are,

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213 *Id.* Judge Suhrheinrich theorized that § 547(c) defenses could be used in general by *Deprizio* defendants who have no liability under § 547(b), and whose liability springs only from § 550(a)(1) as the initial transferee of someone else’s voidable preference. *Id.*

214 The reason that the § 547(c)(4) defense should be put to double use is that the debt owed to the supplier and guaranteed by the nonrecourse surety were one and the same debt.
happily, beyond the scope of this Article.215 Meanwhile, section 547(c)(4) has a curious limitation. According to that provision, the trustee cannot avoid a transfer “to or for the benefit of a creditor, to the extent that, after such transfers, such creditor gave new value . . . .”216 This emphasized language would seem to require that the very creditor who is the defendant in a voidable preference case must be the one who gives back the new value to or for the benefit of the debtor.

In a tripartite case, this requirement can be vexatious. Suppose an initial transferee is being sued because the transfer benefited some insider who is not being sued. Later, that insider gives back new value to the debtor. Because of the trope “such creditor,” it would appear that the initial transferee cannot assert the new value given by the insider. Thus, even though the beneficiary has totally reimbursed the debtor’s estate, the bankruptcy trustee can obtain a windfall by pursuing the initial transferee.

This limitation is not without its logic. Properly speaking, section 547(c)(4) is in the nature of a setoff. Only the creditor being sued for a voidable preference should be entitled to set off the extension of new value. Just as the mutuality requirement in setoff law217 prohibits a creditor from asserting the claim of some stranger as a setoff, so section 547(c)(4) prohibits the use of some stranger’s new value by way of setoff.218 To be compared is the defense in section 547(c)(1), where a voidable preference defendant can cite the new value exchanged by some stranger, so long as the exchange was intended as part of a single transaction.219 Section 547(c)(4), being based on setoff, operates on a different principle.

D. The Surety as Account Debtor

When an existing unsecured creditor receives a subsequently created suretyship right, which is in turn contemporaneously secured by the debtor’s collateral, the surety’s security interest is a transfer on antecedent debt, but the surety has the section 547(c)(1) defense. So long as the “two transfer” theory is applied, as it should be, the assured creditor has no

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215 On this feature of § 547(c)(4), see Carlson, supra note 11.
217 Id. § 553(a) (1988).
218 Id. § 547(c)(4).
219 Id. § 547(c)(1).
such defense.\textsuperscript{220}

These principles become unusually complex when the assured creditor claims a security interest in the debtor's receivables, and when a surety is an "account debtor."\textsuperscript{221} Whether the trustee can recover a voidable preference from either the surety or the assured creditor is a matter of prodigious complexity and caprice. These matters might be litigated under section 547(c)(1), but aspects of the trustee's \textit{prima facie} case are implicated as well.

The ability of the trustee to recover a voidable preference from the assured creditor is the function of the age of three different variables as of the time of the bankruptcy petition: (a) the suretyship obligation, (b) the receivable that the surety owes to the debtor, and (c) the security interest the assured creditor claims against that receivable. Of course, item (c) can never be older than item (b), since a security interest can never antedate the debtor's rights in the collateral.\textsuperscript{222} Also, the age of the security interest in the receivable depends on its perfection within ten days of attachment,\textsuperscript{223} so that if we say that the security interest is of a certain age, we imply that the creditor perfected within that grace period.

In the discussion that follows, we will assume the assured creditor is undersecured. If oversecured, then no transfer by the debtor to either the assured creditor or the surety could be a voidable preference because such a transfer never flunks the hypothetical liquidation test of section 547(b)(5). In addition, the reader must constantly monitor whether the assured creditor is receiving the debtor's unencumbered dollar, an encumbered dollar (paid by the surety over to the secured party as assignee), or a dollar in which the debtor has no interest (paid by the surety in satisfaction of the suretyship obligation).

1. \textit{The Suretyship, the Receivable, and the Security Interest Are All Over Ninety Days Old}

If all of the analytical variables fall outside the ninety day preference period, then the assured creditor may be paid at any time without voidable preference liability. The analysis for reaching this conclusion, how-

\begin{footnotesize}
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\item \textsuperscript{220} See \textit{infra} notes 167-85 and accompanying text.
\item \textsuperscript{221} U.C.C. § 9-105(1)(a) (1994) ("'Account debtor' means the person who is obligated on an account, chattel, paper or general intangible.").
\item \textsuperscript{222} 11 U.S.C. § 547(e)(3) (1988).
\item \textsuperscript{223} \textit{Id.} § 547(e)(2)(A), \textit{as amended} by Bankruptcy Reform Act, \textit{supra} note 8, § 203, 108 Stat. at 4122.
\end{itemize}
\end{footnotesize}
ever, is rather complicated.

Suppose the debtor pays the assured creditor with unencumbered dollars. The transfer is a *prima facie* voidable preference, but this is precisely where the assured creditor has a section 547(c)(1) defense. Every such dollar the assured creditor receives reduces the surety's right to set off its contingent subrogation claim against the debtor's claim against the surety. This reduction in the setoff opportunity enriches the debtor dollar for dollar, thereby establishing the assured creditor's section 547(c)(1) defense.224.

No defense exists, though, so long as the debtor is paying down what can be called the "insufficiency."225 To the extent that the subrogation claim exceeds the surety's obligation as account debtor, payment to the assured creditor does not return value to the bankrupt estate. For example, if the debtor owes the assured creditor $100 and the surety owes the debtor $80, a $20 insufficiency exists. The first $20 that the debtor pays the assured creditor does not reduce the surety's setoff rights. Rather, it eliminates the surety's insufficiency. This initial payment depletes the bankrupt estate and is therefore preferential, but all additional payments reduce the setoff opportunity of the surety *pro tanto*. As a result of a second $20 being paid over, the debtor's estate shrinks by $20, but the debtor's claim against the surety—formerly worth zero because of the set off right—is now worth $20. The debtor's gain offsets the debtor's loss, and so the assured creditor (via the surety) has given back new value contemporaneously with its receipt of the $20 payment.

Thus, where a surety is undersecured, payments to the assured creditor are voidable preferences. Once the unsecured deficit claim has disappeared, every dollar the debtor pays to the assured creditor reduces the surety's setoff rights, thereby enriching the debtor. From this point, the assured creditor can assert the section 547(c)(1) defense because new value is being returned to the debtor.

The section 547(c)(1) defense exists only when the debtor pays the assured creditor with unencumbered dollars.226 If the dollars are supplied

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224 The assured creditor is therefore in the position of the supplier of oil in Gulf Oil Corp. v. Fuel Oil Supply & Terminaling, Inc. (In re Fuel Oil Supply & Terminaling, Inc.), 837 F.2d 224 (5th Cir. 1988), discussed supra note 189 and accompanying text.

225 11 U.S.C. § 553(b)(2) (1988) (insufficiency is defined as the "amount, if any, by which a claim against the debtor exceeds a mutual debt owing to the debtor by the holder of such claim"). Section 553(b)(2)'s definition is, properly speaking, applicable only to § 553(b), which is not yet implicated in the discussion. Section 553(b) attempts to prevent a creditor from improving her position through setoff within 90 days of bankruptcy.

by the surety, the section 547(c)(1) defense is no longer relevant, and the 
analysis must follow one of two divergent paths, although each path leads 
to the same result. The two paths exist because, in the context at hand, 
the surety owes the assured creditor twice over. First, the surety owes the 
assured creditor under the suretyship agreement. Second, the surety owes 
the assured creditor as assignee of her obligation on the receivable. It is 
necessary, then, to determine which debt the surety is paying when she 
transfers dollars to the assured creditor.

When a payor owes a creditor two different debts, the payor is enti­
tled to declare what a given payment means.227 For example, the surety 
might declare that she is paying the suretyship obligation—not the receiv­
able owed to the debtor. In such a case, the payment by the surety can 
ever be a voidable preference in the debtor’s bankruptcy because the pay­
ment is not a transfer of debtor property.228

Once the surety pays her suretyship obligation, the surety has estab­

227 SAMUEL WILLISTON, A TREATISE ON THE LAW OF CONTRACTS 388-89 (3d ed. 1972) 

228 See National Bank of Newport v. National Herkimer County Bank, 225 U.S. 178 (1912). In 
that case, the debtor had a claim against its affiliate. It was also liable on a promissory note held by a 
bank. Shortly before bankruptcy, the affiliate purchased the debtor’s note held by the bank and used it 
to set off its obligation to the debtor. Then, as now, assignments of unsecured claims during the 
preference period obtained to create a setoff were disallowed. See Bankruptcy Act § 68(b); 11 U.S.C. 
§ 553(a)(2) (1988). The affiliate, however, was insolvent and had no assets. The bankruptcy trustee 
therefore tried to recover from the bank on a preference theory. Apparently, the trustee alleged that 
the money paid by the affiliate to the bank was in fact the debtor’s property—proceeds of the receiv­
able the affiliate owed the debtor. If so, then the bank received debtor property on antecedent debt.

The lower court had ruled that the bank could not be liable for the preference because it was 
never the transferee of debtor property. Mason v. National Herkimer County Bank, 172 F. 529, 531 
(2d Cir. 1909), aff’d, 225 U.S. 178 (1912). In affirming, Justice Charles Evans Hughes was appar­
ently keen to deny that only transferees could be defendants in voidable preference actions. 225 U.S. 
at 184. National Bank of Newport therefore constitutes the birth of the tripartite preference case, and 
its principles were eventually made explicit in statutory language. The reason that the bank had not 
received a preference, however, was that “[i]t was not shown that the bank had anything to do” with 
the initial transferee’s collateral. Id. at 187. By this Justice Hughes presumably meant that the affili­
ate’s payment to the bank was not cash proceeds of the debtor’s account receivable. Id. at 186. Rather, 
the dollars paid were not the debtor’s property but the assignee’s own property. As such, the assignee 
was like the surety who declares that a payment is on the suretyship obligation, but not a payment of 
the receivable.

Justice Hughes also thought that the setoff meant that the debtor had made no transfer of prop­
erty and had simply suffered the extinguishment of one of its receivables. 225 U.S. at 185 (“The fact 
then is not . . . that ‘the bankrupt parted with property . . . and the bank received it,’ but rather that 
the bankrupt parted with nothing, and the bank received then money of the [affiliate] and redelivered 
to the [affiliate] the paper . . . .”). This view that setoffs are not transfers is probably overruled by 
§ 550(a), which allows a trustee to recover illegal setoffs under § 553(b) from either the “initial trans­feree” or the person benefited. See supra notes 70-85 and accompanying text.
lished a vested suretyship claim against the debtor. This suretyship claim can be used to set off the surety’s obligation on the receivable owed to the debtor. If this occurs, the trustee has no voidable preference recovery against the surety, for the simple reason that the setoffs cannot be voidable preferences. Section 553(a) provides, in relevant part, that:

\[\text{this title does not affect any right of a creditor to offset a mutual debt owing by such creditor to the debtor that arose before the commencement of the case under this title against a claim of such creditor against the debtor that arose before the commencement of the case . . . .}^{230}\]

This language means that the surety’s setoff can never be deemed a voidable preference, at least so far as the surety is concerned.\(^{230}\)

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\(^{230}\) Section 553(a) validates setoffs generally, but several exceptions are also set forth. Three of these exceptions entail events occurring within 90 days of bankruptcy. 11 U.S.C. § 553(a)(2)-(3), (b) (1988). Since we are stipulating that the surety’s obligation to the debtor is over 90 days old by the time of bankruptcy, none of these exceptions is relevant.

In addition, § 553(a) requires that, for a setoff right to exist, the two countervailing debts must be “mutual.” \(\text{Id.} \; \text{§} \; 553(a)\). This may pose a problem for the surety who pays the suretyship obligation instead of paying the receivable. Thereafter, the surety must try to set off the subrogation claim against its obligation to pay a receivable that the debtor assigned to the secured party. Where the surety pays the suretyship obligation in full, the assured creditor’s security interest entirely disappears. This disencumbers the receivable and makes it fully mutual for setoff purposes. Where the surety pays less than the full amount of the suretyship obligation, or where the receivable secures debt the surety never guaranteed, the surety may set off the subrogation claim against the encumbered account, but only if the surety’s obligation to pay the receivable arose after the suretyship obligation. This follows from U.C.C. § 9-318(1)(b), which provides:

\[\text{[t]he rights of an assignee are subject to (b) any . . . defense or claim of the account debtor against the assignor which accrues before the account debtor receives notification of the assignment.}^{240}\]

U.C.C. § 9-318 (1)(b) (1978). Where the temporal order is reversed, the assured creditor can claim that the setoff is invalid as against her right to collect as assignee.

A contrary case is Kent-Reese Enters., Inc. v. Hempy, 378 F.2d 910 (9th Cir. 1967), where the receivable was older than the suretyship agreement and both were older than the preference period. The assured creditor claimed no security interest in the receivable.

Just before bankruptcy, the surety paid off the assured creditor and then declared a setoff to extinguish the surety’s obligation to the debtor. The trustee sued on thereceivable, as if the setoff were invalid. Writing for the Ninth Circuit, Judge Marvin Jones ruled in favor of the trustee, holding that the trustee should recover from the surety because the assured creditor had taken no security interest in the debtor’s receivables. \(\text{Id.} \; \text{at} \; 912-13.\)

This is a \textit{non sequitur}. Why should the secured party’s failure to take a security interest in the receivable prevent the surety’s right to setoff? Had the assured creditor held a security interest in the receivable, the setoff would have been improper because the debts would not have been mutual. \(\text{See} \; 11 \; \text{U.S.C.} \; \text{§} \; 533(a) \; (1988).\) The debtor would have had a claim against the surety, and the surety would have owed the countervailing claim to the secured party as assignee. Contrary to Judge Jones’ opinion, the absence of the security interest was the \textit{sine qua non} of the setoff—not a reason to invalidate
Under state law, however, setoff is subject to the rule of "use it or lose it." Thus, if the surety pays the receivable before its contingent suretyship claim becomes fixed, no mutual debt exists when it comes time to exercise the setoff.

The surety did not take this advice in *Citizens' National Bank v. Lineberger (In re Kirby-Warren Co.)*, yet an overly generous court came to the aid of the surety and the assured creditor. In this case, a surety who owed a receivable to a debtor had also co-signed the debtor's notes. In an eleventh-hour workout, the surety, an insider, borrowed money from the assured creditor, used the money to pay down the receivable, and caused the debtor to pay the same money back to the assured creditor. The bankruptcy trustee sued the assured creditor for voidable preference and should have recovered. The assured creditor had received unencumbered property of the debtor and had no security interest in receivables. The surety had forfeited the setoff right by paying the receivable instead of declaring the setoff. Yet the assured creditor still prevailed against the bankruptcy trustee. In essence, Judge John J. Parker allowed the parties to recharacterize the transaction after the fact for their own benefit. Judge Parker effectively treated the surety's payment to the debtor as a payment to the assured creditor (not a payment on the receivable) followed by a setoff of the receivable.

The above discussion assumes that the surety chose to pay the suretyship obligation and not the receivable. When this occurred, the assured creditor was entirely immune from the trustee's voidable preference theories—proving, incidentally, that the assured creditor need not rely on any security interest encumbering receivables in order to prevail. But another assumption is also possible: if the security agreement between the debtor and the assured creditor is in default, or if the security agreement provides for direct payment to the assured creditor, the surety may choose instead to pay the receivable. Payment of the receivable to the assured creditor extinguishes the guaranteed debt, thereby relieving the surety *pro tanto* of any suretyship obligation to an unpaid assured creditor.

45 F.2d 522 (4th Cir. 1930).

In dissent, Judge Elliott Northcott protested that the assured creditor's president was the brother-in-law of the surety, that the entire arrangement was crooked, and that no such help to the parties was deserved. *Id.* at 531-32 (Northcott, J., dissenting).

Judge Parker had a bad year in 1930. Besides the *Kirby-Warren* case, Parker was also narrowly rejected by the Senate after President Hoover nominated him to the Supreme Court. See John C. McCoid II, *Moore v. Bay: An Exercise in Choice of Law*, 1990 ANN. SURVEY BANKR. LAW 157, 187 n.70 It is not known whether the reasoning in *Kirby-Warren* contributed to Judge Parker's demise.
If the surety’s payment to the assured creditor implies payment of the receivable, the trustee can have no voidable preference recoveries. Such a payment of the receivable to the assured creditor means that the assured creditor has received possession of her own cash proceeds. The surrender of cash proceeds to a secured party with a valid security interest is never preferential because the surrender never runs afoul of the hypothetical liquidation test. Therefore, thanks to section 547(b)(5), the trustee cannot recover when the surety pays the proceeds of the receivable directly to the assured creditor.\(^{233}\)

2. The Receivable or the Suretyship Arose During the Preference Period on Antecedent Debt

The conclusion that the assured creditor might escape voidable preference liability when the surety is also an account debtor depends on the assumption that the surety has a valid setoff. A valid setoff means that, when an assured creditor receives unencumbered dollars from the debtor, the assured creditor can assert the disappearance of the surety’s setoff opportunity as a section 547(c)(1) defense. Section 553(a) validates setoffs generally, but it also sets forth exceptions:

\[(2)\text{ such claim was transferred, by an entity other than the debtor, to such creditor...}\]
\[(B)(i)\text{ after 90 days before the date of the filing of the petition; and (ii) while the debtor was insolvent; or}\]
\[(3)\text{ the debt owed to the debtor by such creditor was incurred by such creditor...}\]
\[(A)\text{ after 90 days before the date of the filing of the petition; (B) while the debtor was insolvent; and (C) for the purpose of obtaining a right of setoff against the debtor.}\(^{234}\)

Section 553(a)(2) will not affect the surety’s setoff right even when the receivable arises within the ninety day preference period. This subsection requires the surety to obtain a countervailing claim against the debtor through transfer or assignment. The creation of the receivable arises through transfers from the debtor which section 553(a)(2) excludes by its terms. Rather, the suretyship creates a contingent claim in the surety, without any transfers of rights from the assured creditor. For this reason,

the suretyship agreement created in the ninety day period before bankruptcy can never violate section 553(a)(2). 238

Section 553(a)(3), however, may provide an impediment to the surety's valid right of setoff. If the surety borrows from the debtor within ninety days of the debtor's filing for the purpose of establishing the setoff, the setoff will be disallowed. 236 Or, where the receivable is old and the suretyship is new, the setoff will not be allowed when the suretyship was for the purpose of obtaining a setoff. In either case, the surety/account debtor will continue to owe the receivable to the debtor, and the trustee may recover the receivable as if no setoff occurred. 237 On the other hand, if the surety signs a suretyship agreement and then borrows for some honest purpose, or if the suretyship was not undertaken for the purpose of obtaining the setoff, then the surety can exploit a setoff opportunity because no part of section 553(a) is offended. If the setoff is legal, then the assured creditor has a section 547(c)(1) defense.

Earlier we saw that, between senior and junior secured parties, setoff rights arising during the preference period for the benefit of the senior secured party potentially benefit the undersecured junior party. 238 These observations, valid in context, cannot lead to the conclusion that the assured creditor is liable for the setoff opportunity the surety has received within the preference period. The surety's late-arising setoff rights probably do not "benefit" the assured creditor within the meaning of section

236 It is true that subrogation resembles transfer. But subrogation exists alongside and in addition to the self-generated rights of the surety. That is, the self-generated right of the surety is her contingent claim against the debtor for indemnity. Subrogation is the assignment of the assured creditor's fixed claim. Both rights exist side by side. Hostmann v. First Interstate Bank (In re XTXonix Technologies, Inc.), 156 B.R. 821, 828-29 (Bankr. D. Or. 1993) (more or less concurring with this proposition). This distinction is honored by Bankruptcy Code § 509, which provides:

(a) Except as provided in subsection (b) or (c) of this section, an entity that is liable with the debtor on, or that has secured, a claim of a creditor against the debtor, and that pays such claim, is subrogated to the rights of such creditor to the extent of such payment. (b) Such entity is not subrogated to the rights of such creditor to the extent that- (1) a claim of such entity for reimbursement or contribution on account of such payment of such creditor's claim is- (A) allowed under section 502 of this title; (B) disallowed other than under section 502(e) of this title; or (C) subordinated under section 510 of this title; or (2) as between the debtor and such entity, such entity received the consideration for the claim held by such creditor.

11 U.S.C. § 509(a)-(b) (1988). The upshot of this provision is that a surety can claim against the debtor in her own right or through subrogation, but not both. Subrogation involves a transfer of rights from the assured creditor to the surety, but a surety also has a claim against the debtor in her own right, without regard to any transfer.


238 See supra notes 70-85 and accompanying text.
547(b)(1). The reason they do not is that, at best, the setoff opportunity is like a security interest issued to the surety after the suretyship obligation arose. Such security interests may not benefit the assured creditor because the assured creditor already had the right to collect from the surety under the suretyship agreement. That the surety obtains a security interest for its subrogation claim is of no concern to the assured creditor.

We also saw earlier that the principle from the new Restatement of Suretyship, which subrogates the assured creditor to the surety’s security interests, interfered with the conclusion of “no benefit.” The Restatement, however, can have no effect here. There is no way for the assured creditor to benefit from the surety’s setoff opportunity. The setoff opportunity can only be exercised after the suretyship obligation has become vested, which happens only when the assured creditor has been paid. Therefore, by the time the setoff opportunity can be used, the assured creditor has already been paid and therefore can never benefit from the setoff opportunity.

The trustee needs to destroy the surety’s setoff in order to destroy the assured creditor’s section 547(c)(1) defense. Section 553(b) is another provision to which a trustee might look for such vengeance because it attempts to strike down improvement of the surety’s position during the ninety days prior to bankruptcy. As we are assuming the suretyship obligation predates the receivable, it is very likely that the surety has indeed improved her position. But section 553(b) has a key limitation in that it requires that the surety actually manifest an intent to set off prior to the bankruptcy petition. If no setoff is manifested, section 553(b) does not apply.

Because of this limitation, it is very unlikely that section 553(b) will help the trustee establish a voidable preference theory against the assured creditor. If the debtor has paid the assured creditor with unencumbered dollars, the setoff opportunity disappears, as does any chance for the surety to manifest the setoff. With no manifested setoff, section 553(b) cannot apply to reduce the setoff right.

To summarize, if the surety has a valid setoff, the trustee likely will have trouble recovering any voidable preference when the surety’s obliga-

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289 See supra notes 32-44 and accompanying text.
290 See supra note 33-34 and accompanying text.
291 Of course, any event occurring after the assured creditor has been paid by the surety cannot benefit the assured creditor, so that the assured creditor could have no liability under § 547(b).
tion to the debtor arises shortly before bankruptcy. The security interest, however, is surely a voidable preference. It will be of no extra help to the secured party. But the assured creditor will nevertheless have a valid section 547(c)(1) defense if the surety has a valid setoff. As always, if the surety pays the assured creditor directly on the suretyship obligation, the trustee has no voidable preference case against the assured creditor because the assured creditor has received no transfers of debtor property.

There is one possible slip-up of which sureties should be aware. If the surety accidentally pays the receivable before paying the suretyship obligation, the setoff right may be lost, and the surety will be an unsecured creditor in the debtor’s bankruptcy. Even here we saw at least one court willing to aid the surety by recharacterizing the payment of the receivable as in fact a payment of the suretyship obligation. But sureties should not expect such generosity from the courts again, especially when they are insiders of the debtor.

E. Receivables and Inventory

When the assured creditor claims a security interest in inventory or receivables, the surety will usually enjoy the same defense the assured creditor has under section 547(c)(5). So long as the secured claim is guaranteed, any transfer of inventory, receivables, or proceeds to the assured creditor is for the benefit of the surety. But this benefit is not a voidable preference when section 547(c)(5) applies. According to the opening words of section 547(c)(5):

(c) 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, . . .

To this defense is appended a very long “except” clause, which is designed to prevent a secured party (or her surety) from improving her position over the preference period:

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243 If the surety’s setoff fails under § 553(a)(3), the secured party would like a valid security interest in the late-arising receivable. She may have a defense under § 547(c)(5), depending on the facts. On this defense, see infra notes 245-75.

244 Citizens’ Nat’l Bank v. Lineberger (In re Kirby-Warren Co.), 45 F.2d 522 (4th Cir. 1930); see supra note 231 and accompanying text.


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 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 such security interest; . . . 247

According to this complicated exception, if the difference between the debt and the collateral decreases over the relevant preference period, the defense created by the opening words of section 547(c)(5) is reduced by the amount of that decrease. 248

As section 547(c)(5)(A)(ii) indicates, the one year reach-back period of section 547(b)(4)(B) may apply if insiders are involved. 249 But, surprisingly, if an insider has guaranteed repayment to a party with a security interest in inventory or receivables, the one year reach-back period is not necessarily applicable. According to section 547(c)(5)(A)(ii), the one year test is conducted "with respect to a transfer to which subsection (b)(4)(B) of this section applies . . . ." 250 Subsection (b)(4)(B) specifically refers to a period "between ninety days and one year before the date of the filing of the petition, if such creditor at the time of the transfer was an insider." 251 Therefore, the one year test must apply to security interests created between ninety days and one year before bankruptcy. Thus, it is an error to assume that the one year period universally applies in the section 547(c)(5) calculation, just because an insider is implicated. 252 Rather, the

247 Id.
248 For exhaustive analysis of this proposition, see Irving A. Breitowitz, Article 9 Security Interests as Voidable Preferences, 4 CARDozo L. REV. 357 (1982); Carlson, supra note 11.
250 Id.
251 Id. § 547(b)(4)(B).
252 Richard F. Duncan, Preferential Transfers, The Floating Lien, and Section 547(c)(5) of the Bankruptcy Reform Act of 1978, 36 ARK. L. REV. 1, 33-34 (1982). In Still v. Congress Fin. Corp., 137 B.R. 263 (Bankr. E.D. Tenn. 1992), Judge Ralph Kelley saw that the one year period might apply, but he missed the point that the test applies only to certain of the security interests that benefited insiders. Instead, he applied the one year test to all the security interests, even if they arose during the 90 day period. Id. at 269. Application of the one year test in this way violates the literal terms of § 547(c)(5)(A)(ii).
one year period applies only when one of the voidable preferences was transferred before the ninety day period began. In other words, only when some of the items of inventory or collateral are very old will the one year test apply, and even then, it applies very specifically to the older inventory or account items.

Because the ninety day test applies to all relevant security interests created within the ninety day period, while the one year test applies only to transfers made during the ninety day to one year period, the proper calculation of improvement in position contains some surprises. By way of example, suppose that the assured creditor has an after-acquired property security interest on all inventory of the debtor, and an insider of the debtor has guaranteed this claim. Suppose also that the inventory consists of widgets worth a dollar apiece. Widgets turn over frequently and therefore have a short shelf life. The assured creditor has a $100 claim, and, on the date of the bankruptcy petition, there are precisely 100 widgets. Ninety days before bankruptcy, the debt was $100 and there were only eighty widgets. One year before bankruptcy, the debt was $100 and there were only thirty widgets.

Suppose that all 100 widgets were acquired a few days or weeks before bankruptcy. In that case, the only test used to determine improvement of position is that described in section 547(c)(5)(A)(i), even though insiders are involved. Because all the transfers are those “to which subsection (b)(4)(A) . . . applies,” we are required to compare the insufficiency in the security that exists on the ninetieth day before the date of the bankruptcy ($100 debt - $80 in widgets = $20) with the insufficiency in the security that exists on the date of the bankruptcy ($100 in debt - $100 in widgets = 0). The assured creditor has therefore improved her position by $20. As a result, the assured creditor has a valid security interest in $80 of the widgets and is liable for having received $20 worth of voidable preferences. Of course, as an insider, the surety is liable for the voidable portion of the security interests, which constitutes $20 in “benefits” within the meaning of section 547(b)(1). But by no means does the “insider” status of the surety, standing alone, invoke the one year test.

Suppose now that ninety-nine of the widgets were acquired a few days before bankruptcy, with one other widget having been on the shelf for 100 days. In this case, section 547(c)(5)(A)(i) applies to the security interests on ninety-nine of the widgets, while section 547(c)(5)(A)(ii) applies to the security interest on the one aged widget, because that one
transfers is "a transfer to which subsection (b)(4)(B) ... applies." According to the ninety-nine widgets, we calculate "any amount by which the debt secured by such security interest [$100] exceeded the value of all security interests for such debt [$80]" on the ninetieth day. The insufficiency with regard to the ninety-nine widgets is $20. Next, we calculate the insufficiency on the bankruptcy date. On that day, we are to find the "aggregate of all such transfers" to the assured creditor. "Such transfers" means the transfers that are voidable under section 547(b). There are $100 worth of such transfers. The insufficiency at bankruptcy is $100 - $100 = 0. So far, of the ninety-nine widgets, the trustee disencumbers $20 worth, and the secured party retains $79 worth of widgets.

Now we must account for the one widget to which the one year period in section 547(c)(5)(A)(ii) applies. According to this new test we must find the insufficiency on the day one year prior to bankruptcy. On this day, the debt was $100 and there were thirty widgets. On bankruptcy day, there was zero insufficiency. Therefore, the trustee is able to disencumber up to seventy widgets. There is only one widget to which this portion of the test applies. Accordingly, the trustee may disencumber it. The final result is that the assured creditor has a security interest on only eighty widgets. The assured creditor is liable for the voidable security interest on twenty widgets. The insider, however, is worse off. It "benefited" from the $20 improvement in position during the preference period, and, in addition, from the one transfer that occurred in the insider period. Therefore, the insider's total liability is $21. Notice that this result is different from the one we might reach if the ninety day test or the one year test were used against all the widgets together. If we applied the ninety day test to all of the insider's "benefit," the insider would have had a liability of $20. If we applied only the one year test, the insider's liability would have been $70.

Under this improvement-in-position test, the position of the assured creditor and the insider grows worse as the inventory grows older. By way of illustration, suppose that ninety-nine of the widgets are over ninety days old, and only one was recently acquired. Because at least ninety-nine of these widgets existed on the ninetieth day before bankruptcy, the insuf-
ficiency on that day cannot be less than $100 - $99 = $1. Let us assume this is true. The insufficiency on the date of bankruptcy is still zero. Therefore, the trustee disencumbers the one and only widget that is subject to the ninety day test, and, so far, the secured party retains ninety-nine widgets in collateral and loses one. Meanwhile, as to the ninety-nine widgets the secured party is allowed to keep, these "benefited" the insider surety, and therefore the insider can be made liable for them, depending upon the section 547(c)(5) calculation. As to that calculation, the insufficiency one year before bankruptcy was $70. The insufficiency on the date of bankruptcy is still zero. Therefore, the assured creditor and the surety have improved their position by $70. The trustee can use this $70 to impose liability on the insider. This $70 voidable preference can no longer be charged to the assured creditor now that Deprizio is repealed. 287 But the insider can be made to pay for the "benefit" obtained from the $70 in security interests transferred during the insider period. Thus—at least in our example, where improvement in position occurred in the insider period—the older the inventory, the greater the liability of the insider surety. Before, the assured creditor had $79 of collateral. Now the insider has only $29 worth. Once again, this result is different from the result reached by simply using either the ninety day or the one year test. If the one year test had been used, the trustee could only disencumber $70 of inventory in total, not $71. It is not apparent why the insider's liability should increase the longer the inventory sits on the shelf. But this seems to be the import of the improvement-in-position test when insiders are involved.

In applying these tests, it should be emphasized that section 547(c)(5) makes only the transferee's improvement in position relevant. Any improvement in position of a non-transferee is irrelevant. This point was fully recognized in Still v. Congress Finance Corp. (Southern) (In re Southwest Equipment Rental, Inc.), 288 where a receivables lender being held liable under a Deprizio theory was able to assert a section 547(c)(5) defense. Judge Ralph Kelley decided to apply the one year test found in section 547(c)(5)(A)(ii) to check for the secured party's improvement of position. 289 On its own, this was erroneous. The one year test should only have been applied with regard to receivables that were over ninety days

289 Id.
old on the date of the bankruptcy. All other security interests should have been tested under the ninety day test of section 547(c)(5)(A)(i), even though an insider was involved. Judge Kelley was correct in allowing the secured party to see whether its position had been improved over the one year period. Section 547(c)(5) does not require us to test whether the insider had improved the insider's position. The two tests will not be the same, as the following example will show.

Suppose again that the assured creditor has a $100 claim against the debtor and has an after-acquired property security interest in widgets worth $1 a piece. Ninety-one days before bankruptcy, the debtor obtains $80 in widgets. These widgets still exist in the debtor’s estate, and so the one year test applies to them. Suppose further that, one year before bankruptcy, the debtor owned no widgets at all, so that the acquisition of $80 in widgets is an $80 naked improvement of position.

These security interests may have benefited the insider, if the insider was undersecured. If so, the trustee has a prima facie case against the insider, unless section 547(c)(5) provides a defense. On the facts heretofore supplied, the insider has pure improvement of position. But now suppose that the insider has borrowed $50 from the debtor more than one year before. This $50 account payable constitutes a security interest in the debtor’s bankruptcy because it constitutes a setoff opportunity against the surety’s still-contingent subrogation claim.

As section 547(c)(5) measures global improvement in position—not just the improvement that stems from the receivables—the one year test shows that the insider started off with an insufficiency of $50—the $100 claim minus the $50 setoff opportunity. The insider thereafter improved her position by ending up fully secured in the bankruptcy. Therefore, a $50 improvement of position under the one year test has occurred.

According to Judge Kelley’s reasoning, the assured creditor’s improvement of position is tested. Since all $80 constitutes an improvement in position over the one year period, the secured party is worse off under Judge Kelley’s formulation than under a perspective that examines the insider’s improvement of position. Nevertheless, this formulation is precisely what section 547(c)(5) seems to require. Fortunately, section 547(c)(1) comes to the rescue again. If the secured party receives an addi-

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260 See supra notes 247-56 and accompanying text.
261 137 B.R. at 269.
263 See Carlson, supra note 11.
tional account or item of inventory, then the secured party will not have to resort to the surety. Every dollar of forbearance the surety enjoys directly enriches the debtor, because the surety will likewise forbear asserting the setoff right or other security interest the surety may validly own. This value to the debtor establishes the defense under section 547(c)(1).

These principles are difficult enough that they elude the courts from time to time. Thus, in Wilson v. First National Bank (In re Missionary Baptist Foundation of America, Inc.), Judge Irving Goldberg indicated that the ninety day preference period should apply. But a close examination of the facts in Wilson reveals that a debtor and several affiliates had signed a security agreement under which any of their receivables were collateral for advances to the debtor. That is, the subsidiaries were insider guarantors of the debtor. Thus, perhaps the one year period of section 547(c)(5)(A)(ii) should have been applied to the older receivables, making each of the various subsidiaries potentially liable to the bankruptcy trustee of each of the other subsidiaries. Furthermore, the secured party should have had Deprizio liability for any of these security interests.

Missionary Baptist Foundation had a further complication. After the security agreement was signed, the debtor acquired a new subsidiary that owned receivables. The new subsidiary, however, never signed the security agreement. Therefore, the court implicitly relied upon some additional undisclosed agreement or restitutionary principle to establish that the new subsidiary was obliged to pay for advances made initially to the debtor. Nevertheless, the secured party obtained proceeds from the new subsidiary’s receivables and used them to pay down the claim against the debtor. To the extent the new subsidiary acquiesced to the bank’s collection of its receivables, it was volunteering to pay the debt of its corporate parent. Each voluntary payment probably established a new subrogation claim against the debtor, but in advance of such volunteerism, the secured party never could have compelled the subsidiary to pay.

Payment of another’s debts by an insolvent debtor might constitute a fraudulent transfer if no reasonably equivalent value is received in re-

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284 796 F.2d 752 (5th Cir. 1986).
285 Id. at 760 (“The bankruptcy court made no specific findings of fact on this issue. Instead, the court simply stated that ‘the evidence does not support the trustee’s position that the bank improved its position within 90 days of bankruptcy.’
286 E.g., Smith v. Creative Fin. Management, Inc. (In re Virginia-Carolina Fin. Corp.), 954 F.2d 193, 196-98 (4th Cir. 1992) (subsidiary did not sign security agreement but was deemed the debtor because it actually received the loan proceeds); Ray v. City Bank & Trust Co. (In re C-L Cartage Co.), 899 F.2d 1490 (6th Cir. 1990) (same).
Now if the new subsidiary had not signed the security agreement, it is possible that the subsidiary had very little debt at all. If not, it is possible that the new subsidiary was solvent, and payments made on behalf of its parent might not be fraudulent conveyances. Alternatively, if the secured party advanced funds to the debtor for use by the new subsidiary, the new subsidiary might have a restitutionary duty to repay the funds it received. If so, the new subsidiary might have been insolvent at the time it made payments, but these payments would have been on account of antecedent debt. As such, the payments were transfers for a reasonably equivalent value and therefore not fraudulent transfers, within the meaning of section 548(a)(2) of the Bankruptcy Code. To be sure, they might be voidable preferences, but only in the new subsidiary's bankruptcy. The debtor's bankruptcy trustee had no right to recover these funds. Whatever the avoidance theory, it belongs to the subsidiary's bankruptcy trustee, not the principal obligor's bankruptcy.

Judge Goldberg answered this question differently. Apparently recognizing that the security interest in the new subsidiary's receivables was defective, he stated that the secured party has "at best, an unperfected security interest." This unperfected security interest in turn implied that the secured party somehow gave value because the giving of value is one of the elements of attachment under the Uniform Commercial Code.

In any event, citing the strong arm power of section 544(a), Goldberg allowed the trustee of the debtor (not the new affiliate) to "avoid as preferential payments made on an account that was not covered by a properly

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268 Id. That a solvent subsidiary may pay a shareholder's debts free from either voidable preference or fraudulent transfer liability draws a sharp criticism from Professor Harry Fletcher, who observes that such payment reduces the value of the equity shares the debtor owns, thereby prejudicing the debtor's unsecured creditors. For this reason, he suggests that the judge-made "earmarking" doctrine be eschewed when the financing unsecured creditor is also the subsidiary of the debtor. Fletcher, supra note 149.
269 11 U.S.C. § 548(d)(2) (1988) (defining value to mean "satisfaction or securing of a present or antecedent debt . . . ").
270 Obtaining cash proceeds is never preferential, so long as the original security interest was not itself voidable. See supra notes 83-85 and accompanying text. No such principle could help the secured party in the new affiliate's bankruptcy because the new affiliate's receivables were not encumbered by any security interest (because the affiliate never signed the security agreement). Any cash received from the affiliate would have been strictly unencumbered dollars.
271 796 F.2d at 763 n.16 (chastising secured party for not attending to the difference between attachment and perfection of a security interest).
272 Id.
perfected security interest." 274 Such a theory cannot suffice, however, even if we agree that the secured party had an unperfected security interest in the accounts of the affiliate in question. How a hypothetical judicial lien creditor against the debtor should have a hypothetical judicial lien against the property of a nondebtor is left unexplained.

Perhaps Judge Goldberg viewed the debtor and its subsidiaries as substantively consolidated in the bankruptcy of the debtor. That is, the property of the subsidiaries became property of the debtor. But if that is so, the question arises why the debtor’s financing statement should not be sufficient to perfect a security interest in the new subsidiary’s receivables. Yet Judge Goldberg insisted that the financing statement was not competent to do this.

All of this is very confusing and contradictory, but the real reason to emphasize the Missionary Baptist case here is that the secured party was obtaining security interests that benefited insider sureties. Accordingly, any security interest created between one year and ninety days before bankruptcy was subject to the one year test in section 547(c)(5). And, per Deprizio, the secured party would have been liable for any such transfer not protected under the one year test. The ninety day test is appropriate only for those security interests that were less than ninety days old at the time of the debtor’s bankruptcy. None of this was dreamed of in Judge Goldberg’s philosophy of this case, which he treated as consolidated. 275

274 796 F.2d at 763. Judge Goldberg concluded:
We therefore remand this issue for a factual determination as to the amounts from the [new subsidiary’s] accounts that were applied to the Debtor’s loan balance during the preference period; after such a determination has been made the district court is to enter judgment in favor of the Trustee in that amount.

Id.

275 For a similar de facto consolidation of corporate subsidiaries, see Waslow v. MNC Comm. Corp. (In re M. Paolella & Sons, Inc.), 161 B.R. 107 (E.D. Pa. 1991), aff’d mem., 37 F.3d 1487 (3d Cir. 1994). In this case, it does not even appear that the corporate subsidiaries ever signed the security agreement. As a result, no security interest could have attached to those assets. U.C.C. § 9-203(1)(a). Yet Judge Raymond L. Broderick assumed that the assets of the subsidiary were collateral for the loan to the debtor. 161 B.R. at 125-26. To complicate matters, the subsidiaries had been sold by the time of the bankruptcy. See American Cigar Co. v. MNC Comm. Corp. (In re M. Paolella & Sons, Inc.), 1991 Bankr. LEXIS 1181, at 17-18, 87-88, n.26, 101-02, 105 n.33 (Bankr. E.D. Pa.), aff’d in part, rev’d in part on other grounds, 161 B.R. 167 (E.D. Pa. 1991), aff’d mem., 37 F.3d 1487 (3d Cir. 1994). Nevertheless, the encumbered assets of these newly unrelated entities were counted in the § 547(c)(5) calculation with regard to the debtor. Furthermore, the 90 day test was applied; no thought was given to the one year test on the theory that the subsidiaries were insider guarantors of the debtor’s obligation.

The rationale for the de facto consolidation was that the secured party treated the property of nondebtors as if it were debtor property. 161 B.R. at 125-26. But this cannot be a ground for ignoring the rules for attachment. Acting as if your neighbor’s property is your own does not establish your
which undercuts his conclusion that the financing statement of the debtor was incompetent to perfect the security interest in the new subsidiary's receivables.

1. **Fraudulent Transfer Theory**

Suppose that, because of section 547(c)(5), an insider escapes preference liability under both the ninety day and the one year versions of the two-point test, even though some improvement in position can be found in between the points in the test. Some commentators have suggested that such insiders have received fraudulent transfers. If so, then the same fraudulent transfers may be recovered from the assured creditor as initial transferee under section 550(a)(1).

Fraudulent transfer law is partly found in section 548(a)(1), which provides:

The trustee may avoid any transfer of an interest of the debtor in property, or any obligation incurred by the debtor, that was made or incurred on or within one year before the date of the filing of the petition, if the debtor voluntarily or involuntarily (1) made such transfer or incurred such obligation with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made or such obligation was incurred, indebted; . . . .

ownership if the neighbor objects. Similarly, the affiliates must have consented to the security interest before the secured party could look to their property as collateral.
A close reading of section 548(a)(1) reveals that only transfers of debtor property or obligations incurred by the debtor may be avoided. The indirect "benefit" from such transfers or obligations is not actionable under section 548(a)(1)—though under section 550(a)(1), the "value" of transfers may be recovered from "the entity for whose benefit such transfer was made."

But, in order to bring the provisions of section 550(a)(1) into play, the trustee must show that a transfer of debtor property or obligation of the debtor can be avoided under section 548(a). A transfer on antecedent debt to the assured creditor, however, is not likely to be a fraudulent transfer. These are transfers for a reasonably equivalent value, because satisfying or securing antecedent debt is specifically included in section 548(d)(1)'s definition of that term. It is usually agreed that transfers on antecedent debt, even if preferential, are not fraudulent with regard to other creditors.

If a third party takes a transfer as part of a scheme to finance a voidable preference to another, the transfer to the third party may itself be a fraudulent conveyance. This was established in Dean v. Davis, where a debtor borrowed money from a bank using forged notes as collateral. In response to the bank's threat to prosecute, the debtor borrowed money from his brother-in-law in exchange for a mortgage on the debtor's farm. Recently drafted and widely enacted Uniform Fraudulent Transfer Act (U.F.T.A.) now does so, but in a way that avoids Deprizio problems. According to U.F.T.A. § 5(b):

A transfer made by a debtor is fraudulent as to a creditor whose claim arose before the transfer was made if the transfer was made to an insider for an antecedent debt, the debtor was insolvent at that time, and the insider had reasonable cause to believe that the debtor was insolvent.

UNIF. FRAUDULENT TRANSFER ACT § 5(b), 76 U.L.A. 639 (1985). Like the Bankruptcy Code, the preference period for insiders is one year, id. § 9(c), but the insider must have reasonable cause to believe the debtor was insolvent.

Nothing in the U.F.T.A. makes the "person benefited" liable for preferences received by others. Nor is an initial transferee liable for receiving some other person's voidable preference. Therefore, the UFT A cannot be the source of a fraudulent transfer theory in the Deprizio context.

11 U.S.C. § 550(a)(1) (1988). Note that § 548(a) allows for the avoidance of "obligations," but § 550(a)(1) allows for the recovery of "transfers" (or their value).

Id.

Hartman v. First American Bank (In re Jeffrey Bigelow Design Group, Inc.), 956 F.2d 479, 485 (4th Cir. 1992); but see supra note 277 (discussing the Uniform Fraudulent Transfer Act).

The author of the Chicago Note, supra note 276, at 628, tries to fudge this, arguing that the benefit a surety receives when the assured creditor is paid by the debtor is "like" a corporate dividend, which can be a fraudulent transfer. But the difference is palpable. The corporate dividend is a transfer of debtor property. The surety's financial relief at the disappearance of the suretyship obligation owed to the assured creditor does not constitute a transfer of debtor property. This is just the "two transfer" theory rejected in Deprizio. See infra notes 302-22 and accompanying text.

242 U.S. 438 (1917).
When the debtor filed for bankruptcy, the trustee sued the brother-in-law on voidable preference and fraudulent conveyance theories. Justice Brandeis ruled that the bank received the benefit of a voidable preference, but this was an action against the brother-in-law, not the bank. The brother-in-law had given value contemporaneously with the mortgage and therefore was not liable under a voidable preference theory. Yet, the brother-in-law was liable for having participated in a fraudulent conveyance. As Justice Brandeis explained, "A transfer, the intent (or obviously necessary effect) of which is to deprive creditors of the benefits sought to be secured by the Bankruptcy Act ‘hinders, delays or defrauds creditors’ . . . ." A transfer made in the expectation that the debtor might extricate himself from an economic emergency might not be a fraudulent conveyance, Brandeis opined. Thus, it is possible to refinance unsecured debt with secured debt, provided such an expectation of extrication exists. "[b]ut where the advance is made to enable the debtor to make a preferential payment with bankruptcy in contemplation, the transaction presents an element upon which fraud may be predicated.

Davis, then, stands for the proposition that a secured party who knowingly and contemporaneously exchanges value in order to finance a voidable preference is the recipient of a fraudulent transfer and can be the subject of an avoidance action. On the other hand, if the secured party knowingly finances a payment to a creditor that is not a voidable preference, the security interest cannot be a fraudulent transfer. Furthermore, in Davis, the surety did receive a security interest from the debtor. This transfer of debtor property made plausible the fraudulent transfer claim. In the typical Deprizio situation, no such analogous transfer will have occurred.
In the case of inventory financing, a secured party might improve her position over the preference period but nevertheless be protected under section 547(c)(5). This might occur if the secured party makes an undersecured advance during the preference period and later the improvement in position renders the advance fully secured. Or it may also occur if the secured party simply allows interest to accrue over the preference period. One author suggests that the legal improvement in position might nevertheless be a fraudulent transfer if the secured party has an insider guaranty. This suggestion violates the spirit of Davis, which requires that a transferee of debtor property finance a transaction that is, on its own, a voidable preference.

Davis does not support the theory that a legally approved “feeding” of the lien would constitute a fraudulent transfer. In Davis, any direct transfer to the bank would have been a voidable preference. Here, the transfers to the assured party are by definition not voidable preferences. For this reason, the fraudulent transfer theory will ensnare neither the insider surety nor the undersecured party where section 547(c)(5) fully protects the transfers to the undersecured party.

In spite of everything that has just been said, there is some judicial authority suggesting that both the assured creditor and the insider are indeed liable for fraudulent conveyances with regard to transfers that are not voidable preferences. In Bullard v. Aluminum Co. of America, Judge William Campbell held that the assured creditor was guilty of a fraudulent conveyance when it received payment from the debtor nonpreferentially. His reasoning was that the payment of antecedent debt was in bad faith and was therefore not a transfer for value within the meaning of section 67(d)(1)(e), which provided:

Consideration given for the property or obligation of a debtor is “fair” (1)

way. A creditor simply obtained a transfer on antecedent debt more than 90 days before bankruptcy—something the Bankruptcy Code deems legal. Therefore, a fraudulent transfer theory cannot be used in the Deprizio context.

The author of the Chicago Note presents a negligent analysis of Davis, to say the least. He reads this case as proving that, where the unsecured creditors do not benefit from a transaction, the transaction is a fraudulent transfer. Chicago Note, supra note 276, at 619. Under such a reading, any transfer to any creditor could be challenged, so long as the creditors did not like it and the statute of limitations on fraudulent transfer actions has not yet run. In truth, the mortgage in Davis was voidable precisely because the mortgage was implicated in a voidable preference to another creditor.

288 See generally Carlson, supra note 11.
289 See id.
290 Harvard Note, supra note 276.
291 468 F.2d 11 (7th Cir. 1972).
when, in good faith, in exchange and as a fair equivalent therefor property is transferred or an antecedent debt is satisfied . . . .

Today, section 548(d)(1) does not define "reasonably equivalent value" according to any good faith component, so that it is very unlikely that a modern court would hold that unavoidable transfers to creditors could be transfers for no value.

Still, the above definition is repeated under the Uniform Fraudulent Conveyance Act. In states where the old Uniform Fraudulent Conveyance Act is still in effect, and where the trustee can find a creditor with avoidance rights, section 544(b) applies to make the Uniform Fraudulent Conveyance Act effective in a modern bankruptcy. If so, Bullard might stand for the proposition that the initial transferee of the unavoidable transfers on antecedent debt may be liable for receipt of a fraudulent conveyance. Under these circumstances, both the assured creditor, as initial transferee, and the insider who has waived subrogation rights, as the "person benefited" within the meaning of section 550(a)(1), might be liable for transfers on antecedent debt without the aid of voidable preference theory. Bullard, however, does assume that paying one's creditors is "bad faith," something that is hard to argue when voidable preference law smiles benevolently on the practice.

III. DEPRIZIO

For most creditors, transfers on antecedent debt are voidable preferences if they occur within ninety days of bankruptcy. For insiders, the period is extended to one year.

Prior to the 1994 amendments, section 550(a)(1) subjected ordinary creditors to the insider's one year period because they are initial transferees of preferences that "benefited" the insider. This is the famous holding in Levit v. Ingersoll-Rand Financial Corp., universally called "Deprizio" after the debtor, V.N. Deprizio Construction Corporation.

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293 UNIF. FRAUDULENT TRANSFER ACT § 3(a), 76 U.L.A. 639 (1985).
295 874 F.2d 1186 (7th Cir. 1989). Although Deprizio was the first decision at the court of appeals level to ratify the plain meaning of § 550(a)(1), other decisions presaged it by some years. Other courts opposed it on the ground that Congress could not have intended such a result, or because such a result is inequitable. See id. at 1186 n.2 (collecting cases). The leverage of assured creditors to obtain preferences because of insider guarantees was first developed in Thomas E. Pitts, Jr., Insider Guaranties and the Law of Preferences, 55 AM. BANKR. L.J. 343 (1981).
Deprizio is based on a reading of section 550(a). According to that provision:

to the extent that a transfer is avoided under section ... 547 ... the trustee may recover ... from — (1) the initial transferee of such transfer or the entity for whose benefit such transfer was made ... 286

It can be seen easily enough that, once section 547 proclaims a transfer voidable, section 550(a)(1) makes the initial transferee liable whether the initial transferee independently transgresses the elements of section 547(b) or not.

Congress has now substantially repealed the Deprizio doctrine. According to newly amended section 550(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. 287

A few things may be noted about this new provision. First, it applies only to transfers more than ninety days old at the time of the bankruptcy. Deprizio still must be considered good law when the transfer is within the ninety day preference period. Thus, if the initial transferee is an oversecured creditor and some junior undersecured party is benefited, the oversecured party has Deprizio liability for transfers within ninety days of bankruptcy.288

287 Bankruptcy Reform Act, supra note 8, § 202, 108 Stat. at 4126 (amending 11 U.S.C. § 550 by adding new subsection (c)).
288 See supra notes 64-85 and accompanying text. One situation in which Deprizio liability might spring up unexpectedly is when a debtor pays interest to senior debenture holders, where the debenture holders can claim that they are saved under § 547(b)(5), because the insolvent estate was large enough to guarantee senior debt 100 cents on the dollar in a hypothetical chapter 7 liquidation. This result occurs because the senior claimants are entitled to all the dividends that would otherwise go to the junior claimants. The premise of subordination is that junior dividends are uniquely diverted to the designated senior classes, not to all unsecured creditors. This is sometimes called "double dividends," in subordination parlance. David Gray Carlson, A Theory of Contractual Debt Subordination and Lien Priority, 38 Vand. L. Rev. 975, 982 (1985).

Suppose a senior debenture holder can show that the hypothetical liquidation test of § 547(b)(5) protects otherwise voidable payments to the seniors. Such a payment, if within 90 days of bankruptcy, can still be recovered because every such payment to the seniors disencumbers the junior dividends,
Second, the 1994 amendment repeals *Deprizio* when an insider receives the benefit of a transfer to some other creditor. It does *not* repeal *Deprizio* when the insider is the initial transferee and the outside creditor receives the benefit. Thus, if a surety receives a security more than ninety days before bankruptcy, and if the security interest benefits an outside creditor, the bankruptcy trustee may still use the *Deprizio* theory to visit liability upon the outside creditor, even though the transfer was over ninety days old by the time of the transfer. We have already seen that *Taunt v. Fidelity Bank (In re Royal Golf Products Corp.)* was a case in which the surety’s security interest benefited the assured creditor. In *Royal Golf Products*, the security interest was deemed to have been transferred just before bankruptcy because the surety’s security interest was unperfected. But if the security interest had been on antecedent debt within the insider period, the assured creditor could have been held liable, even though the transfer was older than ninety days by the time of bankruptcy. The assured creditor was the “entity for whose benefit such transfer was made” within the meaning of section 550(a)(1) and therefore liable along with the insider.

Third, under new section 550(c), ex-insiders are apparently made exempt from voidable preference liability. For example, suppose a shareholder of the debtor has obtained a security interest from the debtor for an antecedent debt eight months before the bankruptcy, at a time when the debtor is insolvent. A week before bankruptcy, the shareholder sells her shares for next to nothing—the firm having no net worth—and so is an ex-insider. It appears as if such an ex-insider is fully protected under section 550(c). In comparison, section 547(b)(4)(B) is careful to condemn transfers “between ninety 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. . . .” Section 550(c) will obviously overrule the suggestion that insiderhood is measured at the time of the transfer.

Thereby benefiting the junior creditors. Since the senior creditors are the initial transferees of payments that impermissibly benefit the juniors, the seniors will have *Deprizio* liability, even though the senior creditors can claim that the hypothetical liquidation test protects them.

Of course, the senior creditors may still be able to claim the “ordinary course” defense under § 547(c)(2). If it is applicable, the defense may be asserted by the senior and junior creditors alike, thereby choking off *Deprizio* liability. *See supra* notes 169-71 and accompanying text.

*99* 908 F.2d 91 (6th Cir. 1990); *see supra* notes 36-44 and accompanying text.


*01* Prior to this amendment, a controversy existed as to whether a creditor who was an insider at the time an obligation was arranged (but not at the time the obligation was paid or secured) might be subject to the one year period. Some courts stretched § 547(b)(4)(B) to condemn, for example pay-
For at least three reasons, reports on the death of *Deprizio* are slightly, though not greatly, exaggerated.

A. "Two Transfers"

There is no use denying that *Deprizio*, in its day, was a compelling interpretation of section 550(a)(1). Some courts resisted the implication by asserting that Congress did not intend the consequences of section 550(a)(1)'s literal meaning, or that, for equitable reasons, the statute was no longer an insider. Other courts insisted that insiderhood be tested as of the exact time of the challenged transfer. Melissa M. Cowan, *Determining Insider Status Under Bankruptcy Code Section 547(b)(4)(B): When I "Resign" May Not Be Enough to Terminate Insider Status*, 41 U.C.L.A. L. REV. 1541 (1994) (recognizing that § 547(b) imposes *Deprizio* liability without the aid of § 550). Presumably, neither line of cases is valid, in light of the 1994 amendments.

One such attempted denial occurs in Block v. Texas Commerce Bank Nat'l Assoc. *In re Midwestern Cos.*, 102 B.R. 169, 172 (W.D. Mo. 1989), where Judge Dean Whipple thought that the *Deprizio* reading of § 550(a)(1) flatly contradicted § 547(b)(4)(B) and therefore must be wrong. Accord Performance Communications, Inc. v. First Nat'l Bank *In re Performance Communications, Inc.*, 126 B.R. 473, 476-77 (Bankr. W.D. Pa. 1991). But it is all too easy to show that the two provisions are not contradictory. Section 547(b)(4)(B) may limit recovery of transfers made to insiders more than 90 days before bankruptcy, but § 550(a)(1) does not. It does not even require that the initial transferee be guilty under § 547(b).

There is at least one piece of legislative history in favor of the plain meaning. As Judge Charles Baker writes in Mixon v. Mid-Continent Sys., Inc. *In re Big Three Transp., Inc.*, 41 B.R. 16 (Bankr. W.D. Ark. 1983):

> "In the precursor to Section 550 proposed by the Commission on the Bankruptcy Laws of the United States, the primary target of the trustee's recovery was likewise the initial transferee. In explaining this section, the Commission stated that it "covers all initial transferees of recoverable property, not just those preferred.""

_id. at 21 n.1 (citing REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, H.R. DOC. NO. 93-137, 93rd Cong., 1st Sess., pt. 2, at 178 (1973)) (emphasis added). Thus, Judge Baker was persuaded to anticipate the *Deprizio* decision and held that the assured creditor is liable for the surety's voidable preference. Id. at 21.


> "This section is derived from §§ 21g, 60b, 67a(3), 67d(6), and 70d(1) and (5) of the present Act. Those sections partially spell out the relative rights of the trustee and initial and subsequent transferees. The treatment of initial and subsequent transferees varies in each of the sections; some variation is justifiable as to initial transferees, but it is not as to subsequent transferees. Variances required as to the treatment of initial transferees are handled in the avoidance sections.""

_Id. (emphasis added). Others have interpreted this passage to mean that Congress intended initial transferees to be liable only if they themselves were guilty of preference under § 547. David I. Katzen, *DePrizio and Bankruptcy Code Section 550: Extended Preference Exposure Via Insider Guarantees, and Other Perils of Initial Transferee Liability*, 45 BUS. LAW. 511, 529 (1990). Otherwise, a defense in § 547(c) could not possibly be relevant to pure *Deprizio* liability under..."
should not be followed literally. Some argued that section 550(a)(1) granted discretion to a bankruptcy court to hold the “initial transferee” harmless and to direct suit solely against the insider as the “entity for whose benefit such transfer was made.” Section 550(a) does award discretion to judges over whether to order the return of the actual property transferred or its value. But this discretion as to what might be recovered does not serve to suggest discretion as to who should be liable. In the end, the “plain meaning” of the Bankruptcy Code consistently prevailed at the court of appeals level.

The prevailing theory for avoiding the Deprizio result is the so-called “two transfer” theory. According to this theory:

[...] each payment the Debtor made to its creditors which had the indirect effect of benefitting insiders constituted not one but two distinct transfers—one directly to the creditor receiving the payment and one indirectly to the insiders. Therefore, while the “transfers” to the insiders were potentially avoidable during the expanded preference period, the transfers to the non-insider creditors were subject only to the ordinary ninety-day preference period.

§ 550(a)(1).

One commentator complained that this use of the legislative history was illegitimate. He wrote that the Commission report “merely emphasizes that section was applicable to fraudulent and other avoidable transfers, not just preferences.” Isaac Nutovic, *The Bankruptcy Preference Laws: Interpreting Code Sections 547(c)(2), 550(a)(1), and 546(a)(1)*, 41 Bus. Law. 175, 194 n.87 (1985).

See Block v. Texas Commerce Bank Nat’l Ass’n (In re Midwestern Cos.), 102 B.R. 169, 170-72 (W.D. Mo. 1989); Schmitt v. Equibank (In re Beck Builder, Inc.), 34 B.R. 888, 894 (Bankr. W.D. Pa. 1983) (the assured creditor “should not be penalized for its prudence in seeking a guarantor of the debt . . . .”); Seeley v. Church Bldgs. & Interiors, Inc. (In re Church Bldgs. & Interiors, Inc.), 14 B.R. 128, 131 (Bankr. W.D. Okla. 1981) (“Furthermore, this court . . . reaches the same equitable result.”). In terms of the “inequity” in holding an initial transferee who does not herself transgress the elements of § 547(b), it has been pointed out that § 547(b) itself has abandoned scienter and other indicia of moral turpitude, so that § 550(a)(1)’s similar disinterest in morality should not come as any surprise. *Chicago Note, supra* note 276, at 612.


Levit v. Ingersoll Rand Fin. Corp. (In re V.N. DePrizio Constr. Co.), 86 B.R. 545, 550 (N.D. Ill. 1988), aff’d, 874 F.2d 1186 (7th Cir. 1989). *See also* Goldberger v. Davis Jay Corrugated...
The "two transfer" theory is based on the idea that the assured creditor and the insider each received separate transfers. In the words of Judge William Garwood, "Under this theory, only the second transfer is an avoidable preference under section 547(b) because the first transfer, once separated from the second, does not itself benefit the insider guarantor."\footnote{308} As this theory is still relevant to the benefited creditor's standing to assert defenses of the initial transferee, a full examination of it is still worthwhile.

According to Judge Frank Easterbrook, the "two transfer" theory was "an heuristic device to explain how recoveries could be had from indirect beneficiaries under the 1898 Act..."\footnote{309} Under section 60(b) of the Bankruptcy Act, the trustee could only recover from a "transferee," even while section 60(a) condemned transfers for the benefit of non-transferees.\footnote{310} Nevertheless, the Supreme Court had made clear, in dictum, that preferences might be recovered from a person who was not actually the initial transferee of a preference. In \textit{National Bank v. National Herkimer County Bank},\footnote{311} Justice Charles Evans Hughes wrote:

To constitute a preference, it is not necessary that the transfer be made directly to the creditor. It may be made to another for his benefit. If the bankrupt has made a transfer of his property, the effect of which is to enable one of his creditors to obtain a greater percentage of his debt than another creditor of the same class, circuity of arrangement will not avail to save it... It is not the mere form or method of the transaction that the act 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.\footnote{312}

The "two transfer" theory arose to describe this dictum. According to Judge Jerre Williams, who endorsed the theory:

To combat such circuity, the courts have broken down certain transfers into

\footnote{309} Levit v. Ingersoll Rand Fin. Corp., 874 F.2d 1186, 1196 n.6 (7th Cir. 1989).
\footnote{310} Bankruptcy Act § 60(b).
\footnote{311} 225 U.S. 178 (1912).
\footnote{312} \textit{Id.} at 184. Nevertheless, Justice Hughes also ruled that the beneficiary of a transfer was immune from voidable preference liability because "[i]t was not shown that the bank had anything to do" with the initial transferee's collateral. \textit{Id.} at 187.
two transfers, one direct and one indirect. The direct transfer to the third party may be valid and not subject to a preference attack. The indirect transfer, arising from the same action by the debtor, however, may constitute a voidable preference as to the creditor who indirectly benefited from the direct transfer to the third party.313

The “two transfer” theory was necessary to explain why beneficiaries could be sued under section 60(b) of the old Bankruptcy Act. This is no longer true. Section 550(a)(1) extends liability to “the entity for whose benefit such transfer was made.”314 Besides being outmoded, the “two transfer” theory fits poorly in the context of Deprizio because the insider surety has received no transfer of debtor property.316 Rather, the insider’s

313 Kellogg v. Blue Quail Energy, Inc. (In re Compton Corp.), 831 F.2d 586, 591-92 (5th Cir. 1987), modified, 835 F.2d 584 (1988) (per curiam). Judge Jerre Williams used the “two transfer” theory to explain why the bankruptcy trustee could not recover collateral from a bank that issued a letter of credit to an unsecured creditor. Id. at 596. The bank would otherwise have been liable under Deprizio as the initial transferee. Earlier, we approved of this reasoning but reconciled it entirely with the dicta in Deprizio.

Contrary to what was said here, a later opinion from the Fifth Circuit appeared to interpret Compton as opposing the result in Deprizio. In T.B. Westex Foods, Inc. v. Federal Deposit Ins. Corp. (In re T.B. Westex Foods, Inc.), 950 F.2d 1187, 1188 (5th Cir. 1992), a debtor lost a general intangible through garnishment by a judgment creditor. The garnishee refused to pay, and so the judgment creditor garnished again, seizing the bank accounts of the garnishee. Id. This latter garnishment of the garnishee was within a year of bankruptcy, but not within 90 days. Id.

Judge Garwood ruled that the garnishment constituted a “benefit” to the judgment debtor, an insider. Id. at 1192. This part of the case is discussed supra in the text accompanying notes 92-102. He also ruled that the judgment creditor was the initial transferee of the insider’s voidable preference and therefore liable on a Deprizio theory. Id. at 1193-94. In so ruling, he purported to distinguish the “two transfer” theory adopted in Compton. He read Compton as opposing Deprizio by its two-transfer theory (something I have disputed). Garwood affirmed that Deprizio was wrongly decided because of the “two transfer” theory, but, in Westex, there was only one obligation owing to the judgment debtor, which the judgment creditor had managed to garnish, to the benefit of the judgment debtor. As Garwood explained, “Only one transfer occurs because the obligation that is discharged by way of the transfer is indivisible.” Id. at 1194. While Judge Garwood is correct that the facts before him constituted only one transfer, two transfers genuinely existed in Compton. Therefore, it was not necessary to opine that Compton stood in opposition to Deprizio.


316 Judge Easterbrook did not so much deny that a “benefit” might be a transfer. Rather, he insisted that a “transfer” must be analyzed from the debtor’s perspective, not from the multiple creditors’ perspective. Even if the creditors received two transfers, the debtor made only one — and it benefited insiders:

The two-transfer approach equates “transfer” with “benefit received”. Both Lender and Guarantor gain from payment, and each receives a “transfer” to the extent of the gain. The Code, however, equates “transfer” with payments made. Section 101(50) says that a transfer is a disposition of property. Sections 547 and 550 both speak of a transfer being avoided; avoidability is an attribute of the transfer rather than of the creditor. While the lenders want to define transfer from the recipients’ perspectives, the Code consistently de-
suretyship obligation to the assured creditor has disappeared. This disappearance of an obligation to a third party is not readily made into “property of the debtor.” In addition, as one commentator has pointed out:

[T]wo transfers is probably incorrect because it ignores that Congress specifically provided for initial transferees to be liable even though another party may have been the beneficiary of the transfer. If the benefit to the guarantor is viewed as a separate transfer, Congress should never have used the term “initial transferee.”

The renunciation of the “two transfer” theory in the Deprizio context is useful to make clear that any initial transferee who is liable because another creditor was preferentially benefited has full access to the defenses in section 547(c). But this point also depends upon the proposition that a Deprizio defendant is liable under section 547(b)—not just under section 550(a)(1)—as the initial transferee of an avoidable transfer. So long as Deprizio is thought to emanate only from section 550(a)(1), the assertion of section 547(c) defenses by Deprizio defendants is illogical. The defenses of section 547(c) can only prevent liability under section 547(b), not section 550(a)(1). Initial transferees do not have a good faith purchaser

874 F.2d at 1195-96. Accord Clark v. Balcor Real Estate Fin., Inc. (In re Meredith Hoffman Partners), 12 F.3d 1549, 1557 (10th Cir. 1993); Official Unsecured Creditors Comm. of Suffolk, Inc. v. United States Nat’l Bank (In re Suffolk, Inc.), 2 F.3d 977, 982 (9th Cir. 1993). See also Ray v. City Bank & Trust Co. (In re C-L Cartage Co.), 899 F.2d 1490, 1493 (6th Cir. 1990) (“The approach incorrectly equates ‘transfer’ with ‘benefit received.’ ”).

316 In Kellogg v. Blue Quail Energy, Inc. (In re Compton Corp.), 831 F.2d 586 (5th Cir. 1989), it was possible to see that the benefited creditor received debtor property. There, a bank had issued a standby letter of credit to a supplier on antecedent debt. In exchange, the debtor granted the bank a security interest. Under the proper analysis of that case, the bank obtained the security interest on the antecedent debt of the supplier. Accordingly, the bank was liable under § 547(b). But, as to this security interest, both the bank and supplier (for whose “benefit” the security interest was granted) had a defense under § 547(c)(1). The story did not end here, though. In exchange for the security interest, the bank extended its credit to the debtor. The debtor ordered the credit—its credit—be transferred to the supplier. This indeed was a “second transfer.” As to this second transfer of debtor property, the supplier was liable to the debtor’s bankruptcy trustee because the supplier had no defense with regard to this second transfer. So analyzed, Compton and Deprizio are in complete accord. See supra notes 183-85 and accompanying text.

317 Isaac Nutovic, supra note 303, at 193 n.82. See also Block v. Texas Commerce Bank Nat’l Assoc. (In re Midwestern Cos.), 102 B.R. 169 (W.D. Mo. 1989) (rejecting Deprizio on other grounds).

defense in section 550(a), but transferees of transferees do, under section 550(b)(1). Initial transferees must therefore rely on the defenses found in section 547(c), or they have no defense at all.319

Deprizio, decided under section 550(a), could have been decided from the words of section 547(b) alone.320 Section 547(b) proclaims as “void” transfers received by the initial transferee if some other creditor benefited preferentially. Thus, even though the transfer is not preferential if the beneficiary is ignored, the initial transferee is holding property of the estate that must be returned.321 On the theory just presented, beneficiaries

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319 One commentator opposes extending § 550(b)(1) defenses to “creditors” liable under § 547(b) because that would invade the turf of the § 547(c) defenses. Henk J. Brands, Note, The Interplay Between §§ 547(b) and 550 of the Bankruptcy Code, 89 Colum. L. Rev. 530 (1989). If, however, an initial transferee is not a creditor liable under the prima facie rules of § 547(b), then according to this commentator, extending the § 550(b)(1) defense to such transferees cannot undermine the § 547(c) defenses. Id. at 548. Therefore, courts should go ahead and treat the assured creditor as a transferee of a transferee, even though she is only the initial transferee. Id.

Although not consistent with a literal interpretation of § 550(a)(2), this approach would allow courts to permit the assured creditor to escape whenever the assured creditor is in good faith. The author concludes by noting that his idea “makes unnecessary an elaborate factual inquiry to determine the equity of recovery in a specific case. Thus it provides a more certain standard than the vague equitable standard, and it is easier to apply.” Id. at 549.

These last remarks are mysterious in that the equitable theory simply refuses to make the assured creditor liable. This equitable theory is the one that is factually easy. Adjudicating the good faith of the assured creditor, however, is likely to be factually messy. In any case, this approach depends on the willingness of a court to deem that the initial transferee is really a transferee of a transferee, contrary to the “plain meaning” of these words. Thomas D. Buckley, Insider Guaranties, Their Effect on the Bankruptcy Preference “Reach Back” Period and Possible Use in Getting an “Ordinary Course” Exception From Avoidance, 22 U. Tol. L. Rev. 247, 283 (1991). Just because ignoring the plain meaning does no violence to § 547(c), does not prove that the plain meaning of § 550(b) ought to be ignored.

In any case, the suggestion depends upon the notion that the Deprizio defendant is “innocent” under § 547(b). I am just about to suggest, however, that the standard Deprizio defendant was fully liable under § 547(b), without any reference to § 550(a). See infra notes 320-22 and accompanying text.


321 In support of this proposition, it can be noted that, when a bankruptcy case is dismissed, according to § 349 of the Bankruptcy Code, “any transfer avoided under section . . . 547” is resurrected. It does not say that transfers voided under § 550(a) are resurrected. This proves that § 547(b) is capable of avoiding transfers all by itself. Similarly, § 551 provides that “[a]ny transfer avoided under section . . . 547 . . . is preserved for the benefit of the estate . . . .” 11 U.S.C. § 551 (1988). This likewise implies that § 550(a) is superfluous to the Deprizio theory.

In despatching Deprizio, the House Judiciary Committee scuttled S.540 and substituted its own bill, including the above amendment to § 550. The Senate version, however, would have been ineffective in repealing Deprizio, if it is accepted that § 547(b) in isolation compels the Deprizio result.
of the initial transfer have access to any defense under section 547(c) that the initial transferee could have asserted. If the beneficiary has a valid defense, then the initial transferee is equally off the hook because, now, no one is liable for a voidable preference. The premises of *Deprizio* fail, and the initial transferee cannot be held liable under either section 547(b) or section 550(a). Therefore, section 547(c) defenses are fully adequate to prevent *Deprizio* liability because *Deprizio* liability arises from the language of section 547(b).

According to the Senate's version of the amendment:

The trustee may recover under subsection (a) a transfer avoided under section 547(b) from a first transferee or an immediate or mediate transferee only to the extent that

1. all the elements of section 547(b) are satisfied as to the first transferee; and
2. the exceptions in section 547(c) do not protect the first transferee.

S.540, § 214 (1994). This amendment assumes that the *Deprizio* result arises solely from § 550(a)(1) and not from the text of § 547(b) itself. If, however, *Deprizio* is justified out of the language of § 547(b), then the proposed legislation just quoted would not have sufficed to kill *Deprizio* off. This is because the *Deprizio* first transferee has satisfied "all the elements of § 547(b)," and therefore the bankruptcy trustee could recover from the initial transferee, the same as before.

If § 550(a)(1) was unnecessary to *Deprizio*'s theory, are we then saying that § 550(a)(1) is superfluous? No. Section 550(a) contributes to voidable preference jurisprudence (as well as to fraudulent transfer jurisprudence) by making clear that non-transferees can be held liable. The fact that initial transferees could be held liable was always well understood under the old Bankruptcy Act. According to § 60(b):

Any such preference may be avoided by the trustee if the creditor receiving it or to be benefited thereby . . . has, at the time when the transfer is made, reasonable cause to believe that the debtor is insolvent. Where the preference is voidable, the trustee may recover the property or, if it has been converted, its value from any person who has received or converted such property . . .

Bankruptcy Act § 60(b) (emphasis added). According to this statute, the trustee could only recover from a "transferee." Yet § 60(a) condemned transfers for the benefit of non-transferees. This anomaly is precisely what gives rise to the "two transfers" fiction—to explain how a trustee might recover from a non-transferee.

What § 550(a) adds—and why it is not superfluous if § 547(b) directly avoids transfers—is a more direct statement that beneficiaries of transfers are liable for the benefit caused by the initial transfer. Section 550(a) therefore replaces the "two transfers" fiction.

If § 60(b) permitted the trustee to pursue the initial transferee for a preference that is voidable only because of the benefit bestowed on an insider, why is it that *Deprizio* did not arise under the old Bankruptcy Act? The answer is simple. Under old § 60(b), insiders were subject to the same preference period (four months) as any other creditor. Therefore, the *Deprizio* phenomenon could not arise. That is, either the assured creditor and surety were both liable, or they were both innocent. For example, a transfer made six months before bankruptcy could not be recovered from either the assured creditor or the surety. Only when Congress elected to extend the preference period for insiders and shorten it for all other creditors did the circumstances arise for *Deprizio* liability.

In support of this view, some legislative history suggests that a defense in § 547(c) might be used by an initial transferee to defend against liability under § 550(a)(1). Senator Edward DiConcini and Congressman Don Edwards both read the following identical statement into the record:

The liability of a transferee under section 550(a) applies only "to the extent that a transfer is avoided." This means that liability is not imposed on a transferee to the extent that a
The renunciation of the “two transfer” theory is essential to provide access to the section 547(c) defenses. If the benefit is one transfer, and the initial transfer is another, it is impossible to explain why the initial transferee should be able to assert the defense of the beneficiary or vice versa. Only if the transfer and the benefit enjoy a unity can both the initial transferee and beneficiary assert each other’s defenses.

B. Oversecured Creditors

*Deprizio* did not usually pose a threat to oversecured creditors. If the debtor paid an oversecured creditor, the hypothetical liquidation test would have shielded the insider.\(^3^2^3\)

There are some exceptions to this analysis. First, suppose the trustee could make out a case of equitable subordination against an insider transferee is protected under a provision such as section 548(c) which grants a good faith transferee for value of a transfer that is avoided only as a fraudulent transfer, a lien on the property transferred to the extent of value given.

\[124\text{ Cong. Rec. 32400 (1978) (statement of Sen. Edwards); 124 Cong. Rec. 34000 (1978) (statement of Rep. DiConcini). If a defense from § 548(c) works to protect an initial transferee under § 550(a)(1), then so would a defense under § 547(c). Lowrey v. First Nat'l Bank *(In re Robinson Bros. Drilling, Inc.)*, 97 B.R. 77, 82 (D. Okla. 1988) (dictum), aff'd, 892 F.2d 850 (10th Cir. 1989) (per curiam); Miller v. Steinberg *(In re Marilyn Steinberg Enters., Inc.)*, 141 B.R. 587, 597-98 (Bankr. E.D. Pa. 1992). *Deprizio*, however, arises not from § 550(a)(1), but from § 547(b). For this reason, any defense a beneficiary may assert under § 547(c) is capable of choking off *Deprizio* liability because § 550(a)(1) liability requires a finding that § 547(b) has been violated.\(^3^2^3\)

For a case involving an oversecured party, see General Motors Acceptance Corp. v. Rodgers *(In re Laguna Beach Motors, Inc.)*, 148 B.R. 317 (Bankr. 9th Cir. 1992). In *Laguna Beach Motors*, the owner of an automobile, as to which a secured party had a perfected security interest, surrendered possession to a car dealer. The owner kept the title documents and only granted the dealer an option to buy the automobile in case it could make a profitable resale. The dealer sold the car but did not pay the owner immediately. Later, after several demands, the dealer paid the owner. Most of the purchase price was sent directly to the secured party. The dealer then filed for bankruptcy.

The dealer’s trustee argued that the payment to the secured party was “for the benefit” of the car owner, and as initial transferee of the payment, the secured party was liable under § 550(a)(1) for the owner’s voidable preference. Although Judge John Ryan ruled for the trustee, Judge Robert Clive Jones reversed on appeal because application of *Deprizio* would have been “inequitable.” *Id.* at 321.

A better rationale for deciding the case is based on the fact that, in California, ownership of the car is never transferred until the owner endorses the certificate of ownership or mails notice of the transfer to the California Department of Motor Vehicles. *Cal. Veh. Code* § 5600 (West 1987). The owner of the car only received cash when he surrendered documents and so had never received payment on antecedent debt. If the owner and the secured party gave up documents simultaneously with receiving cash, then no party received a voidable preference. Although the payment to the owner was pursuant to an earlier executory contract, the “debt” was not created when the dealer and the owner entered into the option agreement. At this time, the dealer had no present obligation to pay. Only when the dealer accepted the certificate of title did the dealer become obligated to pay. As this occurred contemporaneously with payment, no transfer on antecedent debt was implicated.
surety, but not against the oversecured creditor. Equitable subordination is capable of depriving the insider of any security interest inherited through subrogation. Therefore, the insider may flunk the hypothetical liquidation test, even though the oversecured party does not. Yet, because the oversecured party is the initial transferee of the insider’s preference, it has liability after all.

A second situation threatens an oversecured party. Suppose a subsequent junior undersecured party appears. The debtor now pays the senior oversecured party just before bankruptcy. The payment benefits the junior secured party by freeing up collateral that otherwise would have been necessary to collateralize the senior claim. As the senior secured party is the initial transferee of the voidable preference—and as the transfer was not within the insider period or even for the benefit of an insider—the senior secured party continues to have Deprizio liability for the payment. This liability makes anti-pledge covenants in the senior security agreement even more desirable than they were previously, since junior secured parties can trigger a Deprizio theory against the senior oversecured party.

If the senior secured party is made to return a payment because the

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326 Id. at 356-57. This situation actually arose in Deprizio, where a senior oversecured party enjoyed no guaranty at all and was sued for being the initial transferee of a voidable preference that benefited the insiders (by further securing the junior secured party, who did have a guaranty). The matter was remanded to the bankruptcy court by Judge Easterbrook, but he did speculate as follows:
Lender #1 extends credit and takes security. It is so over-secured that Lender #2 is willing to make a second loan and take a junior security interest. This second loan (but not the first) is backed up by an insider’s guarantee. Every payment to Lender #1 increases the amount of security available for Lender #2, which produces a benefit to Guarantor by reducing his exposure. The trustee seeks to recover all payments to Lender #1 during the year before the filing, even though Lender #1 did not negotiate for an insider’s guarantee. . . . [W]e have substantial doubt that the payments to Lender #1 are avoidable transfers. By assumption Lender #1 is over-secured, so its position has not been improved relative to a Chapter 7 liquidation. The benefit in such a case is negligible at best, so the case for recapture is weak. Because neither the bankruptcy court nor the district court considered this question in detail, we do not resolve it, but the Trustee has an uphill battle.
874 F.2d at 1200 (citations omitted). These remarks do not seem consistent, however, with the spirit of the rest of the opinion. If there were only one oversecured party, payments to that secured party would not “benefit” the insiders; indeed, the payments would not have met the hypothetical liquidation test of § 547(b)(5). But the benefit to the insiders when a guaranteed junior undersecured party exists is obvious. The payment to the senior oversecured party means that the junior undersecured party will now receive more collateral, benefiting the insiders, who now have less exposure. Since the senior secured party is the initial transferee of the insiders’ voidable preference, the senior secured party should clearly be liable.
327 Baker, supra note 63, at 147.
payment benefited a junior secured party and an insider surety, the senior secured claim revives. Therefore, recovery from a senior secured party may not increase the bankrupt estate, but at least it allows for the debtor to obtain some cash in exchange for a security interest in non-liquid collateral—a kind of involuntary postpetition loan—and with no need to adequately protect the junior secured parties. Or it may be the case that the collateral no longer exists by the time of the debtor’s bankruptcy. The collateral, freed up when the senior secured party is paid, may have been pledged elsewhere, or sold. In such a case, recovery from the senior secured party enriches the bankruptcy estate.

Professor Thomas Buckley tries to argue against *Deprizio* liability of the senior secured party by denying that transfers to the senior secured party benefit the junior secured party. According to Buckley, a transfer to the senior secured party is simultaneously a transfer directly to the junior secured party, indicating that there are two transfers. If so, then the junior secured party is not indirectly benefited by the transfers to the senior secured party but rather is a direct transferee of collateral otherwise dedicated to the senior claim. The consequence of such an approach is that two unrelated transfers have taken place, and therefore the senior secured party cannot be the initial transferee of the junior secured party’s voidable preference. So conceived, no *Deprizio* liability can be laid on the

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328 Peter Borowitz states that the secured party will not have to return the payment. Instead, the trustee will let the senior secured party retain the payment, avoid the security interest to the extent of the payment, and preserve that senior security interest for the benefit of the estate under § 551 so that it may be asserted against the junior secured party. Peter L. Borowitz, *Waiving Subrogation Rights and Conjuring Up Demons in Response to Deprizio*, 45 BUS. LAW. 2151, 2166 (1990). This suggestion does not comport very well with § 550(a)(1), which gives the court discretion to order the return of the property conveyed or its value. As the remaining security interest is neither the property transferred (i.e., unencumbered cash) nor the value of the property transferred, it is hard to see how the court can order the avoidance of a perfectly valid security interest when the trustee wants cash.

329 In a voluntary postpetition loan where a senior security interest is granted the lender, the junior secured parties are entitled to adequate protection of their subordinated security interests. 11 U.S.C. § 364(d)(1)(B) (1988). Where a junior secured party suffers an instant demotion because the trustee has made payments to the senior oversecured party, the junior secured party should not be able to claim that this consequence of avoidance gives rise to a right to adequate protection.

330 Buckley, supra note 319, at 283. If the original secured party has perfected by filing, the financing statement may continue to stay on file. Under the U.C.C.’s “first to perfect or file” rule, the secured party would continue to be senior when its secured claim revives. Professor Buckley wonders whether the secured party can resist the debtor’s demand that a termination statement be submitted under U.C.C. § 9-404, on the ground that the secured party is “committed” to lend by virtue of being potentially liable for a voidable preference—a concern for debtors who are not even likely to be bankrupt. Id. at 283 n.114.

331 Id.

332 Id. at 284-85.
doorstep of the senior secured party.

What Buckley does not do, however, is explain why payments or other transfers to the senior secured party constitute a new transfer of collateral to the junior secured party. The creation of a security interest is defined as the agglutination of the three elements of attachment, plus perfection, as regulated by section 547(e)(2) of the Bankruptcy Code. The junior secured party received a transfer when the junior security interest was created and perfected. But how does it receive another, separate security interest when the senior secured party is endowed with either cash (extinguishing all or part of the senior claim) or further collateral? If a security interest is a power to sell the debtor interest in the collateral at the time the security interest attached, then the junior secured party had all of this power when the junior security interest was created. The senior security interest continues to have this senior power of sale—a power that can terminate the junior security interest. That the senior claim now has additional collateral not otherwise available to the junior secured party, or that the senior claim has shrunk through payment, does not affect the seniority of the power of sale, nor does it affect the status of the junior power of sale. When property changes value, there has been no necessary transfer of property. The only thing affected is the value of this junior power of sale. Therefore, it is hard to conceive of the junior secured party receiving a direct transfer from the debtor because the senior secured party was paid or further secured. Professor Buckley’s suggestion must therefore be rejected as a mere revival of the “two transfer” theory.

IV. CONCLUSION

Tripartite preference cases arise because the trustee may recover a transfer (or its value) either from the creditor receiving the transfer or from a creditor enjoying the benefit of a transfer to someone else. Over-shadowing these cases is the louring presence of the Deprizio case, which holds that innocent “initial transferees” must return a transfer if some other insider creditor enjoyed the benefit. This holding, based on the clear meaning of section 550(a)(1), effectively extended the preference period from ninety days to a year whenever a creditor takes a guaranty from an insider of the debtor. This holding has now largely been overthrown by Congress in new section 550(c) of the Bankruptcy Code.

Even if Deprizio is largely repealed, many problems will remain in

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334 Id. § 9-504(4).
the analysis of tripartite voidable preference cases. As we have seen, the definition of "benefit" is quite controversial. The precise definition of "antecedent debt," given the contingent nature of subrogation claims by sureties, also raises difficult issues. The limit on the trustee's ability to recover the value of a security interest (instead of simply avoiding the security interest) has largely been left to the discretion of courts, which have yet to work out a very coherent policy on governing this choice. And finally, defenses based upon new value supplied by a person other than the defendant in the voidable preference case have proven very difficult to fathom. This article has attempted to contribute to the learning on all of these subjects. Even though *Deprizio* has not survived the wrath of Congress, these issues will continue to pose the most difficult issues in the generally difficult arena of voidable preference law.