Summer 2018

Check Clearing and Voidable Preference Law Under the Bankruptcy Code

David G. Carlson
Benjamin N. Cardozo School of Law, dcarlson@yu.edu

Recommended Citation

David G. Carlson, *Check Clearing and Voidable Preference Law Under the Bankruptcy Code*, 73 Bus. Law. 627 (2018).
https://larc.cardozo.yu.edu/faculty-articles/800

Check Clearing and Voidable Preference Law Under the Bankruptcy Code

*By David Gray Carlson**

Every business practice must withstand the critique of federal voidable preference law—an adjunct to the principle that unsecured creditors should be treated equally in bankruptcy. This article surveys how well the check clearing system fares under the voidable preference critique. Check clearing involves short-term unsecured and secured credit extended to customers by depositary banks. The fate of a bank in its customer's bankruptcy differs, according to which kind of credit is extended. In the case of an overdraft, banks have preference risk, but they also have powerful defenses to muster against liability. Credit advanced against the deposit of checks is secured credit, for which the risk is smaller but still existent. This latter case is the environment in which check kiting operates. This article explores the fate in bankruptcy proceedings of the lucky bank that escapes the kite without loss.

Contents

* Professor of Law, Benjamin N. Cardozo School of Law. I am grateful to Kenneth C. Kettering and Thomas E. Plank for detailed, excellent, and challenging comments that have vastly improved this article.

Sound banking practice must be wary of federal voidable preference law, which prohibits unsecured creditors from receiving payments or security interests within ninety days of bankruptcy. A commercial practice that cannot withstand the critique of voidable preference doctrine will quickly disappear[1] or at least be much transformed and much more costly for the participants.[2]

Recently, bank lawyers in *Sarachek v. Luana Savings Bank (In re Agriprocessors, Inc.)*[3] suggested to the U.S. Court of Appeals for the Eighth Circuit that check clearing is worthy of special supra-statutory privilege with respect to voidable preference law. This appeal to blind justice fell on deaf ears.[4] Evidently, banks must adhere to the same preference rules that ordinary unsecured mortals face.

Accordingly, this article tests check clearing systems against the voidable preference critique. Given that the practice of bank collections continues to exist certainly suggests that banks are well able to steer clear of bankruptcy avoidance in ordinary cases. My research confirms this and my analysis does not often disagree with the *results* reached by courts. Less often can I endorse the reasoning that gets a court to the correct intuition.

Intuition is anomial and anti-scientific. Science demands that intuition be reduced to reason and rules, to the extent possible. My goal is to do just that with

1. Laws v. United Mo. Bank of Kansas City, N.A., 98 F.3d 1047, 1051 (8th Cir. 1996), *cert. denied*, 520 U.S. 1168 (1997).

2. Studley v. Boylston Nat'l Bank, 229 U.S. 523, 529 (1913); Sarachek v. Luana Sav. Bank (*In re* Agriprocessors, Inc.), 547 B.R. 295, 309 (N.D. Iowa 2016) ("If a bank that routinely allows a customer to provisionally overdraft its account and make covering payments perceives a customer as entering financial troubles, under the Trustee's rule, the bank would certainly terminate the customer's ability to use the intraday overdrafts out of fear that it would be forced to repay all the covering payments in bankruptcy. A bank's termination of this service would exacerbate the customer's financial trouble and turn what may have been temporary cash flow issues into dire financial straits for the company, precipitating bankruptcy in a case where it need not have occurred."), *aff'd*, 859 F.3d 599 (8th Cir. 2017); Bernstein v. Alpha Assocs. (*In re* Frigitemp), 34 B.R. 1000, 1020 (S.D.N.Y. 1983), *aff'd*, 753 F.2d 230 (2d Cir. 1985).

3. 859 F.3d 599, 605 (8th Cir. 2017).

4. *Cf. Frigitemp*, 34 B.R. at 1020 ("The law provides extraordinary protections to credit exposure incurred in the performance of necessary banking services in recognition of their critical place in commercial transactions.").

regard to the largely untheorized voidable preference cases arising out of the check clearing system.

Bertrand Russell supposedly once said, "A book should have either intelligibility or correctness; to combine the two is impossible."[5] I strive for both in this article. When forced to choose, I opt for precision. There is no disguising the fact that voidable preference law is highly technical. The law of check clearing doubles or triples the challenge. Precision is the goal, but my strategy to achieve some measure of lucidity is to reduce the issues to the simplest possible schematic representation. The cases on checking clearing and voidable preference law are monstrously complex, involving hundreds or thousands of transactions and many millions of dollars. Yet usually the key concept in each case can be presented simply and schematically.

In aid of that goal, Part I gives a description of check clearing as governed by Articles 3 and 4 of the Uniform Commercial Code ("U.C.C."). Part II briefly describes the structure of voidable preference law. Part III categorizes the reported cases, re-theorizing many of them. The cases will be trifurcated between (A) those in which banks extend unsecured credit (overdrafts); (B) cases in which there was no advance of credit at all ("provisional debits"); and (C) cases in which banks make advances against uncollected deposits ("provisional credits"). This last category entails secured transactions that are not as likely to be voidable preferences. Defenses (including some new untried defenses) will be discussed with regard to category (A). Hidden traps with regard to category (C) will be revealed and some new defensive ideas to help banks will be tendered.

I. Check Clearing

Throughout this article, I will refer to *D* (for "debtor") and *D Bank* (standing for *D*'s bank or perhaps for "depositary bank").[6] I will imagine that *D* writes checks[7] on *D Bank*, and *D* usually deposits checks with *D Bank* that are drawn to the order of *D* by *E* on *E Bank*. All the monstrous facts of the cases I discuss will be pared down to extremely simple schematic representations based on *D*, *E*, their respective banks, and the first two weeks of March before an April 1 bankruptcy.

The check clearing system is a brilliant work of social engineering, permitting individuals and businesses to avoid dealing in cash. The system begins with *D* opening a deposit account,[8] thereby becoming a "customer."[9] A deposit account

5. J.L. Bell & A.B. Slomson, Models and Ultraproducts: An Introduction 1 (1969); *see also* Grant Gilmore, *For Arthur Leff*, 91 Yale L.J. 217, 218 (1981) ("the path of the law leads not to the revelation of truth but to the progressive discovery of infinite complexity").

6. U.C.C. § 4-106(2) (2017) ("'Depositary bank' means the first bank to take an item even though it is also the payor bank, unless the item is presented for immediate payment over the counter.").

7. *Id.* § 3-104(f) ("'Check' means (i) a draft, other than a documentary draft, payable on demand and drawn on a bank or (ii) cashier's check or teller's check. An instrument may be a check even though it is described on its face by another term, such as 'money order.'").

8. *See id.* § 4-104(a)(1) ("'Account' means any deposit or credit account with a bank, including a demand, time savings, passbook, share draft, or like account, other than an account evidenced by a certificate of deposit.").

9. *Id.* § 4-104(a)(5) ("'Customer' means a person having an account with a bank and for whom a bank has agreed to collect items, including a bank that maintains an account at another bank.").

is established by a contract between *D Bank* and *D*. Basically, *D Bank* promises to take deposits of cash, wire transfers, checks, and "items."[10] In the case of a deposited check, *D Bank* undertakes to collect *D*'s check drawn by *E* on *E Bank* (the payor bank).[11] In addition to collecting checks drawn on *E Bank*, *D Bank* promises to pay to the order of *D* so long as there are sufficient withdrawable credits in *D*'s favor. Very often *D Bank* promises overdraft protection, in case *D*'s cash management skills misfire. *D Bank* commonly charges fees or interest in case of overdraft credit.[12]

When *D* deposits *E*'s check, *D Bank* will "credit" *D* with what Article 4 usually calls a provisional settlement.[13] I take the usual liberty of improving the terminology of Article 4 by calling this settlement a provisional credit in favor of the customer, or a provisional debit if it is against the customer.[14]

A provisional credit granted by a depositary bank is a mere bookkeeping entry worth nothing at all.[15] *D* has no right to withdraw against a merely provisional credit, and *D Bank* does no wrong if it refuses to permit *D* to draw down on a provisional credit.[16]

The provisional credit stands for the proposition that the customer has deposited a check with its bank, and the bank has undertaken to collect that check for the benefit of the customer. The "vast majority" of deposited checks are successfully collected.[17]

10. *Id.* § 4-104(a)(9) ("'Item' means an instrument or a promise or order to pay money handled by a bank for collection or payment. The term does not include a payment order governed by Article 4A or a credit or debit card slip.").

11. *Id.* § 4-106(3) ("'Payor bank' means a bank that is the drawee of a draft.").

12. According to the leading experts:

> The allowance of overdrafts was long considered in this country as a very special service only provided for very special customers. Now it has become a way of life that, along with the credit card, provides a handy device by which banks have entered the explosive world of revolving credit.

1 Barkley Clark & Barbara Clark, The Law of Bank Deposits, Collections and Credit Cards § 3.04, at 3-77 (rev. ed. 2013).

13. U.C.C. § 4-104(a)(11) (2017) ("'Settle' means to pay in cash, by clearing-house settlement, in a charge or credit or by a remittance, or otherwise as agreed. A settlement may be either provisional or final . . . .").

14. These phrases occasionally appear in Article 4. *Id.* § 4-215(c) & cmt. 10. On provisional debits, see *infra* text accompanying notes 267–79.

15. Bernstein v. Alpha Assocs. (*In re* Frigitemp), 34 B.R. 1000, 1004 (S.D.N.Y. 1983) (provisional credits "are in the commercial world treated as automatic bookkeeping entries made solely to facilitate the collection process"), *aff'd*, 753 F.2d 230 (2d Cir. 1985); Ries v. Firstar Bank Milwaukee, N.A. (*In re* Spring Grove Livestock Exch., Inc.), 205 B.R. 149, 157 (Bankr. D. Minn. 1997) (*D Bank* did not violate customer contract when it canceled provisional credits); *In re* All-Brite Sign Serv. Co., 11 B.R. 409, 413 (Bankr. W.D. Ky. 1981) ("The credit which reflects the deposit, being provisional, is a bookkeeping entry only; no funds actually flow into the depositor's account until collection of the checks is complete, at which time the bank becomes indebted to its customer and the right to setoff fully matures.").

16. The court in *Laws v. United Missouri Bank of Kansas City, N.A.*, 98 F.3d 1047, 1050 (8th Cir. 1996), *cert. denied*, 520 U.S. 1168 (1997), remarks: "A provisional credit, like a line of credit, is no more than the opportunity to obtain funds." This is imprecise. A line of credit is the lender's commitment to extend a loan. A bank issuing a provisional credit has no contractual obligation to extend credit.

17. U.C.C. § 4-210 cmt. 3 (2017).

Successful collection means that *D Bank* (as "collecting bank")[18] has received a positive credit in its account (directly or through intermediary banks)[19] with *E Bank*. When *E Bank* pays *E*'s check by crediting the account of *D Bank*, *D Bank* must "firm up" the provisional credit of *D*.[20] *D*'s provisional credit then becomes withdrawable of right.[21]

The provisional credit that marked *D*'s initial deposit of the *E* check almost always turns into a final settlement. Because this is so, banks often permit their customers to draw on a provisional credit because the deposited check almost always clears.[22] When *D Bank* permits a draw against provisional credits, the bank is no longer a mere collecting agent[23] but is a lender of funds to its customer.[24] Furthermore, it is a secured lender. U.C.C. section 4-210(a) gives *D Bank* a security interest in the deposited item to the extent *D Bank* permits the provisional credit to be drawn down. That withdrawals against provisional credits are secured transactions is of the highest significance for our analysis.

II. Voidable Preference Law

In bankruptcy, unsecured creditors without a priority (but with a timely proof of claim) are treated as equals.[25] If an unsecured creditor receives a payment or other transfer of debtor property just before bankruptcy, voidable preference law requires the creditor to return the transfer to the bankruptcy estate. Voidable preference law, then, discourages unsecured creditors from withdrawing from

18. *Id.* § 4-106(5) ("'Collecting bank' means a bank handling an item for collection except the payor bank.").

19. Typically a subagent or a clearinghouse makes the presentation to *E Bank*. The presenter receives a credit and then acknowledges a debit in favor of *D Bank*.

20. *See id.* § 4-215 cmt. 10 ("If previously [*D Bank*] gave to its customer a provisional credit for the item in an account, its receipt of final settlement for the item 'firms up' this provisional credit and makes it final.").

21. U.C.C. section 4-215(e) provides:

> Subject to (i) applicable law stating a time for availability of funds and (ii) any right of the bank to apply the credit to an obligation of the customer, credit given by a bank for an item in the customer's account becomes available for withdrawal as of right:
>
> (1) if the bank has received a provisional settlement for the item, when the settlement becomes final and the bank has had a reasonable time to receive return of the item and the item has not been received within that time;
>
> (2) if the bank is both the depositary bank and the payor bank, and the item is finally paid, at the opening of the bank's second bank day following receipt of the item.

Id. § 4-215(e).

22. Pioneer Liquidating Corp. v. San Diego Trust & Sav. Bank (*In re* Consolidated Pioneer Mortg. Entities), 211 B.R. 704, 708 n.1 (S.D. Cal. 1997), *aff'd in part & rev'd in part on other grounds*, 166 F.3d 342 (9th Cir. 1999).

23. U.C.C. § 4-201(a) (2017).

24. Many courts dispute that advances on provisional credits are loans. *See infra* text accompanying notes 287–319.

25. 11 U.S.C. § 726(a)(2) (2012). Tardy filers are subordinated. *Id.* § 726(a)(93). In truth, in chapter 7 cases, unsecured creditors are equally entitled to nothing, as the vast majority of such cases are administratively insolvent.

the brotherhood of equality just prior to a bankruptcy petition, on the principle that misery loves company.[26]

Yet bankruptcy law wishes market participants to deal with financially challenged debtors.[27] Therefore, commercial actors may exchange contemporaneous values with the debtor.[28] If values are exchanged contemporaneously, there is no preference. What voidable preference law punishes is transfers on antecedent debt. Voidable preference rears its head and snarls when it observes an extension of unsecured credit followed later by a payment or other transfer on antecedent debt.

Voidable preference law achieves a second goal—punishing creditors who have taken "secret liens"—considered fraudulent by commercial law.[29] Voidable preference law is quite capable of transforming a contemporaneous exchange of cash for a security interest in property—not preferential—into a transfer on antecedent debt. This is done by a series of timing rules, set forth in Bankruptcy Code section 547(e). These are rules that determine when a transfer occurs, which is important for the trustee's *prima facie* case of voidable preference.

A. Timing Rules

Voidable preference law offers three timing rules, only one of which can apply in a given case. The first rule is most favorable to creditors—though not conclusively so. The first rule is pleasingly tautologous. According to Bankruptcy Code section 547(e)(2)(A), a transfer occurs when a transfer occurs—*if* perfection is accomplished within thirty days of the transfer.[30] This thirty-day period is the

---

26. According to the Supreme Court, section 547 is

> intended to serve two basic policies . . . . First, by permitting the trustee to avoid prebankruptcy transfers that occur within a short period before bankruptcy, creditors are discouraged from racing to the courthouse to dismember the debtor during his slide into bankruptcy. The protection thus afforded the debtor often enables him to work his way out of a difficult financial situation through cooperation with all of his creditors. Second, and more important, the preference provisions facilitate the prime bankruptcy policy of equality of distribution among creditors of the debtor. Any creditor that received a greater payment than others of his class is required to disgorge so that all may share equally. The operation of the preference section to deter "the race of diligence" of creditors to dismember the debtor before bankruptcy furthers the second goal of the preference section—that of equality of distribution.

Union Bank v. Wolas, 502 U.S. 151, 160–61 (1991).

27. Barnhill v. Johnson, 503 U.S. 393, 402 (1992) (the voidable preference statute is "designed to encourage creditors to continue to deal with troubled debtors on normal business terms by obviating any worry that a subsequent bankruptcy filing might require the creditor to disgorge as a preference an earlier received payment").

28. *In re* Jones Truck Lines, Inc., 130 F.3d 323, 326 (8th Cir. 1997).

29. Jeanne L. Schroeder, *Some Realism About Legal Surrealism*, 37 Wm. & Mary L. Rev. 455, 462–63 (1996).

30. More precisely, section 547(e)(2)(A) provides that a transfer is deemed made, "at a time such transfer takes effect between the transferor and the transferee, if the transfer if perfected at, or within 30 days after, such time, except as provided in subsection (c)(3)(B)." 11 U.S.C. § 547(e)(2)(A) (2012). The exception, added in 1994, is basically mysterious, David Gray Carlson, *Security Interests in the Crucible of Voidable Preference Law*, 1995 U. Ill. L. Rev. 211, 227–29 [hereinafter Carlson, *Crucible*], but irrelevant to check clearing.

so-called grace period for secured creditors. Perfection is defined as whatever act it takes for a transfer to be valid against subsequent lien creditors.[31]

The second and third rules are less favorable for the creditor. Section 547(e)(2)(B)[32] states that the transfer does *not* occur when the transfer occurs if not perfected within thirty days. Rather, it occurs when it is *perfected*. This rule is quite capable of changing a benign contemporaneous exchange into a voidable transfer on account of antecedent debt.[33] This is done to punish a secured creditor for keeping their liens secret for too long a time.

The third rule in section 547(e)(2)(C)[34] is technical. A voidable preference is defined as a *prepetition* transfer on antecedent debt. Therefore. the third rule applies when a perfectible transfer is never perfected—or is perfected substantially after the bankruptcy petition. If we only had the first two rules, voidable preference law would be flummoxed by an unperfected security interest.[35] Such a transfer would be no transfer at all under the first two rules. Therefore, section 547(e)(2)(C) states that a transfer is deemed to be slightly before bankruptcy where the other two rules do not apply. Like the second, the third rule also is capable of changing a contemporaneous exchange into a transfer by the debtor on antecedent debt.

For our purposes, we shall use only the first rule. That the first rule always applies in check clearing cases is actually regrettable.[36] Blame for this simplifying assumption must be laid at the doorstep of the United States Supreme Court, which, in *Barnhill v. Johnson*,[37] held that a check is not an unperfected conditional payment.

---

31. 11 U.S.C. § 547(e)(1)(B) (2012) ("a transfer of a fixture or property other than real property is perfected when a creditor on a simple contract cannot acquire a judicial lien that is superior to the interest of the transferee"). At least this is so when the transfer involves personal property. With regard to real property, perfection is defined in terms of whatever it takes to prevail against a subsequent good faith purchaser for value who has recorded. *Id.* § 547(e)(1)(A).

32. *Id.* § 547(e)(2)(B) (a transfer is deemed to occur "[a]t the time such transfer is perfected, if such transfer is perfected after such 30 days").

33. For example:

January 1: Start of preference period

January 10: *D Bank* lends $100 to *D* and *D* grants a security interest in a machine.

March 1: *D Bank* perfects the security interest by filing a financing statement.

April 1: Bankruptcy petition

Under section 547(e)(2)(B), the transfer is deemed to occur on March 1. The debt dates from January 10. The transfer is deemed to be on antecedent debt. In real life, this was a contemporaneous exchange of loan for machine.

34. According to this rule, the transferee is deemed made "immediately before the date of filing the petition, if such transfer is not perfected at the later of—(i) the commencement of the case; or (ii) 30 days after such transfer takes effect between the transferor and the transferee." *Id.* § 547(e)(2)(C).

35. One should not forget, however, that, under section 544(a)(1), a bankruptcy trustee is a hypothetical judicial lien creditor as of the bankruptcy petition. As such, the trustee is senior to a secured party unperfected as of the day of bankruptcy, unless the secured party can unearth a state-law grace period, in which case Bankruptcy Code section 546(b) saves the creditor.

36. *Barnhill* is regrettable because it wreaks havoc when a bankruptcy petition is filed after *D* issues a check and before *D Bank* pays the check. David R. Hague, *Turnover Actions and the "Floating Check" Controversy*, 2013 UTAH L. REV. 63. *Barnhill* also contradicts one of the sacred tenets of U.C.C. Article 4—that payment pursuant to a check is proceeds of the check itself. *See infra* text accompanying notes 332–41.

37. 503 U.S. 393 (1992).

In fact, on *Barnhill* reasoning, issuance of a check is no transfer at all. Only the *honoring* of the check is a transfer. In dissent, however, Justice John Paul Stephens argued that a check is a conditional unperfected payment which, if paid within the grace period of Bankruptcy Code section 547(e)(2), relates back to the issuance of the check.[38] In essence, the majority rule is that the payment is causally unconnected to the issuance of the check. This denial of causality means that we need not consider any timing rule other than the tautologous section 547(e)(2)(A). Thus, in check clearing cases, the payment occurs when the payment occurs—when the check is honored. Or the Article 4 security interest in deposited items attaches (and is perfected) when it attaches.[39] All transfers implicated in check clearing fall under section 547(e)(2)(A). Thanks to the Supreme Court, we shall have no secret liens to punish. Or, if there are secret liens, we will nevertheless not punish them, as all security interests under Article 4 of the U.C.C. are self-perfecting.

B. The Trustee's Prima Facie Case

The trustee has the burden of proving the prima facie case of voidable preference.[40] The elements of the trustee's cause of action are set forth in section 547(b). There are six elements the trustee must prove. One of them is contained in the preamble to section 547(b). The other five are in the five enumerated subsections to section 547(b).

The elements of a voidable preference are as follows:

(1) There must be a transfer of debtor property.[41]

(2) The transfer must be to or for the benefit of a creditor.[42] Notice that the creditor liable under this statute need not be a direct transferee. It suffices if a creditor benefits from a transfer to some other person.[43] In our analysis, *D Bank* will always be the initial transferee of *D*'s property and never a nontransferee that is benefited by a transfer it did not receive. This simplifies our analysis considerably.[44]

(3) The transfer must be made on account of antecedent debt.[45] The trustee's case fails if the transferee and the debtor engaged in a strictly contemporaneous exchange of values.

(4) The transfer must be made while the debtor is insolvent.[46] The trustee enjoys a rebuttable presumption that, ninety days prior to the bankruptcy petition, the debtor was insolvent.[47]

38. *Id.* at 404–06.
39. U.C.C. § 4-210(c)(2) (2017).
40. 11 U.S.C. § 547(g) (2012).
41. *Id.* § 547(b) (preamble).
42. *Id.* § 547(b)(1).
43. The classic example is an insider of *D* who guarantees *D*'s payment of an obligation. When *D* pays the obligee, the insider is no transferee, but benefits from the transfer because the guaranty obligation disappears. *Id.* § 547(i).
44. On the voidable preference liability of nontransferees, see David Gray Carlson, *Tripartite Voidable Preferences*, 12 Emory Bankr. Dev. J. 219 (1995).
45. U.S.C. § 547(b)(2) (2012).
46. *Id.* § 547(b)(3).
47. *Id.* § 547(f).

(5) The transfer must have occurred (under our timing rules) within ninety days of bankruptcy.[48] The period is extended to one year if the creditor is an "insider" of the debtor.[49] We shall assume *D Bank* is not an insider and that the ninety-day preference period applies.[50]

(6) The last element is the most metaphysical. This element is sometimes styled the "hypothetical liquidation test."[51] In it we imagine that the alleged transfer has been returned to the bankruptcy estate of the debtor.[52] We generate a hypothetical chapter 7[53] liquidation dividend. We compare this dividend to what the creditor actually received in historical non-hypothetical life.[54] If the transfer allows the creditor to get more in real life than the creditor would have received in the hypothetical bankruptcy, then the creditor has been preferred.

Although this test is abstractly expostulated in the Bankruptcy Code, basically every prepetition transfer by an insolvent debtor on account of an unsecured claim will give the creditor more than the *pro rata* bankruptcy dividend that would have accrued if the transfer had not been made. In contrast, the hypothetical liquidation test protects fully secured creditors from liability. A fully secured creditor is not under any duty to be equal in the bankruptcy.[55] Therefore, if a fully secured creditor obtains more collateral or obtains payment, the bankruptcy estate is not harmed and the unsecured creditors are not diminished. An *undersecured* creditor (without a priority) is not protected by this test, however.

With regard to undersecured creditors, the hypothetical liquidation test implies an important distinction. If an *undersecured* creditor receives *unencumbered* dollars from the debtor, the creditor is never protected by the test. Suppose *C* claims $100 against *D* and has collateral for $30. In the preference period, *D* pays $50 in unencumbered funds to *C*, reducing the claim to $50, for which *C* still enjoys $30 in collateral. *C* flunks the hypothetical liquidation test. We are to imagine the $50 payment returned. The hypothetical bankruptcy dividend is a percentage of the $70 unsecured deficit plus the $30 in collateral. In real life, however, *C* received the $50 payment; in the bankruptcy, it also has the $30 in collateral *and* a percentage dividend based on the $20 unsecured deficit. Real life is richer than hypothetical life. Hence the undersecured creditor is always preferred.

48. *Id.* § 547(b)(4)(A).

49. *Id.* § 547(b)(4)(B). "Insider" is partially defined in section 101(31).

50. In the leading case on checking clearing, however, *D Bank* was indeed found to be an insider by virtue of its close involvement with *D*'s financial affairs. Laws v. United Miss. Bank of Kansas City, N.A., 98 F.3d 1047, 1051 (8th Cir. 1996), *cert. denied*, 520 U.S. 1168 (1997).

51. Gladstone v. Bank of Am., N.A. (*In re* Vassau), 499 B.R. 864, 869 (Bankr. S.D. Cal. 2013). It is sometimes called the "greater amount test," Alvarado v. Walsh (*In re* LCO Enters.), 12 F.3d 938 (9th Cir. 1993), or the "more than test," Madden v. Morelli (*In re* Energy Conversion Devices, Inc.), 548 B.R. 208, 222 (Bankr. E.D. Mich. 2016), or the "preferential effect test." *In re* Ludford Fruit Prods., Inc., 999 B.R. 18 (Bankr. C.D. Cal. 1989).

52. 11 U.S.C. § 547(b)(5)(B) (2012) ("the transfer had not been made").

53. *Id.* § 547(b)(5)(A) ("the case were a case under chapter 7 of this title").

54. *Id.* § 547(b)(5) ("that enables such creditor to receive more than such creditor would receive if . . . (C) such creditor received payment of such debt to the extent provided by the provisions of this title").

55. Secured creditors obtain their collateral under Bankruptcy Code sections 724(b) and 725 before the unsecured creditors obtain distributions under section 726(a).

The matter changes radically if, instead of paying *C* unencumbered dollars, *D* tenders the $30 in cash collateral. According to the test, we imagine that the $30 is returned to the bankruptcy estate. Since *C* is entitled to the $30 collateral in a chapter 7 liquidation, *C* simply takes it right back again. In real life, *C* received $30 plus a dividend on the $70 deficit. In hypothetical life, *C* received $30 plus a dividend on the $70 deficit. *C* has not been preferred. Accordingly, provided the security interest on the collateral is itself not a voidable preference,[56] foreclosure of a valid security interest is never a voidable preference.

It shall be chiseled in stone that, whenever a depositary bank has received cash proceeds[57] of a valid perfected security interest, the depositary bank has not received a voidable preference. Only receipt of unencumbered dollars is capable of being a voidable preference, when the transfer in question is a "payment" of an antecedent debt.

C. Defenses

If the trustee has proved the *prima facie* case of voidable preference, all is by no means lost. The creditor may still prevail under one of nine enumerated defenses under section 547(c). Most of them are irrelevant to depositary banks. The ones of concern are described in the following paragraphs.

1. Contemporary Exchanges

A transfer on account of antecedent debt can be a *prima facie* voidable preference. A contemporaneous exchange of values is not. But "antecedent" is very ruthlessly interpreted. Even a gap of a few hours (where creditor performance precedes debtor payment) renders the transfer a *prima facie* voidable preference.[58] Therefore, section 547(c)(1) provides a little forgiveness. If the parties *intended* a contemporaneous exchange of values and if the *actual* exchange was substantially contemporaneous, the creditor has a defense to liability.[59]

---

56. When the security interest is voidable, courts hypothetically presume that the security interest on the collateral has been successfully avoided. The taking of $30 in collateral is then a new transfer to a completely unsecured creditor. Carlson, *Crucible*, *supra* note 30, at 262–64.

57. "'Cash proceeds' means proceeds that are money, checks, deposit accounts, or the like." U.C.C. § 9-102(a)(9) (2017).

58. See Nat'l City Bank v. Hotchkiss, 231 U.S. 50 (1913) (loan in the morning and security interest in the afternoon; the security interest was deemed to be a transfer on antecedent debt).

59. According to Bankruptcy Code section 547(c)(1), the trustee may not avoid a 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.

11 U.S.C. § 547(c)(1) (2012).

According to the legislative history, the "contemporaneous exchange" defense was designed with checks in mind.[60] By way of example, suppose *D*, about to be bankrupt, wishes to buy a blender from a merchant. If *D* were to pay cash, the merchant has not received debtor property on antecedent debt. Rather there has been a contemporaneous exchange of blender for cash.

Suppose, however, *D* pays by personal check. Issuance of the check is not payment. Rather, the merchant is paid (says the Supreme Court) when the check is honored.[61] Suppose there is a five-day delay between the blender transaction and the honoring of the check. As a *prima facie* matter, the merchant has received a payment on antecedent debt. Nevertheless, the merchant has the section 547(c)(1) defense. The parties intended a contemporaneous exchange of blender for cash. The parties did not intend a credit sale.[62] Therefore, if check clearance is substantially contemporaneous with the blender transaction,[63] the merchant has a defense, in spite of the trustee's successful *prima facie* case.

Section 547(c)(1) is said to be a codification of *Dean v. Davis*.[64] In that famous case, *D Bank* discovered that *D* had pledged forged notes in exchange for a loan. To keep the police out of the case, *D*'s brother-in-law promised *D* that he would pay *D Bank* on *D*'s behalf. In exchange, *D* would grant the brother-in-law a mortgage on *D*'s farm. There was, however, a seven-day gap between the advance of funds and the mortgage deed. According to the Supreme Court:

> The mortgage was not voidable as a preference under § 60b. Preference implies paying or securing a preexisting debt of the person preferred. The mortgage was given to secure Dean [the brother-in-law] for a substantially contemporary advance. The bank, not Dean, was preferred.[65]

Thus, Dean gave new value to *D*—the payment that Dean made directly to *D Bank*. For this advance the brother-in-law was to receive a mortgage. *D* and Dean intended this to be contemporaneous, but the paperwork required time and *D Bank* would not wait. Because the grant of the mortgage was substantially

60. "Normally, a check is a credit transaction. However, for the purposes of this paragraph, a transfer involving a check is considered to be 'intended to be contemporaneous,' and if the check is presented for payment in the normal course of affairs, which the Uniform Commercial Code specifies as 30 days, U.C.C. § 3-503(2)(a), that will amount to a transfer that is in fact substantially contemporaneous." S. Rep. No. 95-989, at 373 (1977). U.C.C. section 3-503(2)(a) has since been repealed.

61. Barnhill v. Johnson, 503 U.S. 393 (1992).

62. Article 2 of the U.C.C. so assumes. "Unless otherwise agreed tender of payment is a condition to the seller's duty to tender and complete any delivery." U.C.C. § 2-511(1) (2017). But "payment by check is conditional and is defeated as between the parties by dishonor of the check on due presentment." *Id.* § 2-511(3).

63. The legislative history mentions thirty days as being contemporaneous in a check clearing case. S. Rep. No. 95-989 at 88 (citing U.C.C. § 3-503).

64. 242 U.S. 438 (1917).

65. *Id.* at 443. The court goes on to hold the brother-in-law liable for having received a fraudulent conveyance. Basically, the brother-in-law was knowingly financing a voidable preference. The case is therefore in the nature of a bulk sale permitting the debtor to flummox the creditors. David Gray Carlson, *The Logical Structure of Fraudulent Transfers and Equitable Subordination*, 44 Wm. & Mary L. Rev. 157, 166 (2003).

contemporaneous with the advance of new value, the mortgage, technically a transfer on antecedent debt, was not voidable after all.

Dean v. Davis was, in effect, the secured refinancing of an unsecured debt. In such cases the exiting creditor has received a voidable preference.[66] Somewhat controversially, unsecured refinancing of unsecured debt has been held not voidable under the pre-Code doctrine of "earmarking."[67] Earmarking requires that a refinancing entity send funds directly to the exiting creditor. Under earmarking, the transfer is thought to be a transfer of *creditor* property to the exiting creditor. Since the creditor does not receive *debtor* property, the first element of the trustee's *prima facie* case of voidable preference fails.

Embarrassingly, if we have *secured* refinancing of unsecured debt, as in *Dean v. Davis*, these metaphysics are thrown out the window. The same transfer to the exiting creditor is deemed to be *debtor* property, and so the exiting creditor has received a voidable preference. For this reason, the earmarking doctrine as usually formulated is incoherent.

Almost twenty years ago, a coauthor and I suggested that earmarking is a bad metaphysical hangover contracted in an era when the voidable preference provision was woefully drafted.[68] In that benighted time, ere codification purged the commonweal, courts invented all sorts of "fictions" designed to make the voidable preference statute function according to its perceived purpose. Since then, statutory drafting has vastly improved, and many of these fictions are displaced by the express text of section 547. We suggested that earmarking is simply pre-Code metaphysical anticipation of the section 547(c)(1) defense. In both cases of secured refinancing and unsecured refinancing of old debt, debtor property is transferred to the exiting creditor. But if the exiting creditor and the debtor intended that the refinancing entity provide "new value" (defined as *unsecured* credit), the exiting creditor could invoke the section 547(c)(1) defense. This theory exploits the fact that section 547(c)(1) does not require the exiting creditor to provide the new value. Section 547(c)(1) uses a passive voice as to new value and requires only that new value be supplied, according to the intent of the debtor and the exiting creditor.[69] In what follows I shall translate earmarking talk into (c)(1) talk.[70]

66. "The bank, not Dean, was preferred," Justice Brandeis remarked. 242 U.S. at 443.

67. *See generally* David Gray Carlson & William H. Widen, *The Earmarking Defense to Voidable Preference Liability: A Reconceptualization*, 73 AM. BANKR. L.J. 591 (1999).

68. For a drafting history of Bankruptcy Act section 60(b), see Bryan Kotliar, Note, *A New Reading of the Ordinary Course of Business Exception in Section 547(c)(2)*, 21 AM. BANKR. INST. L. REV. 211, 218–24 (2013).

69. Carlson & Widen, *supra* note 67, at 591–94.

70. If earmarking is a defense, then the creditor has the burden of proof. 11 U.S.C. § 547(g) (2012). As traditionally conceived, earmarking is part of the *prima facie* case and is therefore the trustee's burden to prove earmarking does not apply. Tolz v. Barnett Bank (*In re* Safe-T Brake of S. Fla., Inc.), 162 B.R. 359, 364 (Bankr. S.D. Fla. 1993).

2. Ordinary Course Payments

The second defense of relevance covers payments made in the ordinary course of business or financial affairs of the debtor and the transferee.[71] This defense (in payment cases) constitutes a kind of *scienter* requirement.[72] Where a creditor uses no unusual leverage to obtain a payment, the creditor is not liable for having received a payment on antecedent debt.

To be emphasized is the fact that the defense applies to *payments*. "Payment" is not a defined term in the Bankruptcy Code. A suitable definition of "payment" is the voluntary transfer of *unencumbered* cash or cash equivalent in satisfaction of an obligation. A payment is the debtor's free, uncoerced act.[73]

If this definition is appropriate, then important transactions are ineligible for the (c)(2) defense. The (c)(2) defense in particular does not apply to other transfers, such as the creation or foreclosure of a security interest or the sale of an asset. Nor would a setoff be a payment because setoff (at least potentially) depends on the will of the creditor, not the will of the debtor.[74]

It routinely happens that a secured creditor is reimbursed, not by *payment* according to this definition, but by the receipt and application of cash proceeds. Receipt of "pre-owned cash" is not a "payment" but rather more in the nature of a foreclosure. The reduction of collateral to cash by collection or sale is governed (rather inadequately) by Part 6 of Article 9 of the U.C.C., whereas the law of payment basically emanates autochthonously from the common law. Satisfaction through cash proceeds differs from "payment" in that the secured creditor already "owns" the cash before satisfaction is accomplished. In a payment, the creditor obtains an ownership interest in the cash *for the first time*. All that

71. According to section 547(c)(2), a trustee may not avoid a transfer

> to the extent that such transfer was in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee, and such transfer was—
>
> (A) made in the ordinary course of business or financial affairs of the debtor and the transferee; or
>
> (B) made according to ordinary business terms . . . .

11 U.S.C. § 547(c)(2) (2012).

72. Lawrence Ponoroff, *Bankruptcy Preferences: Recalcitrant Passengers Aboard the Flight from Creditor Equality*, 90 Am. Bankr. L.J. 329, 338–40, 365 (2016) [hereinafter Ponoroff, *Recalcitrant Passengers*]. Prior to the Bankruptcy Code, the trustee had to prove in general that the creditor had reasonable cause to believe the debtor was insolvent at the time of the transfer, a requirement the Bankruptcy Code eliminated. Vern Countryman, *The Concept of a Voidable Preference in Bankruptcy*, 38 Vand. L. Rev. 713, 726–28 (1985).

73. *See* United States v. Isthmian S.S. Co., 359 U.S. 314, 319–20 (1959) ("'payment' connotes tender by the debtor with the intention of satisfying the debt coupled with its acceptance as satisfaction by the creditor"); Spillman Inv. Grp., Ltd. v. Am. Bank (*In re* Spillman Dev. Grp., Ltd.), 401 B.R. 240, 255 (Bankr. W.D. Tex. 2009) ("Payment is the satisfaction of an obligation in whole or part by 'the actual constructive delivery or money or its equivalent, by the obligor or someone for him to the obligee for the purpose of extinguishing the obligation in whole or in part and the acceptance as such by the obligee.'" (citing Vaughn v. Cent. State Bank, 27 S.W.2d 1112, 1114 (Tex. Civ. App. 1930))).

74. United States v. Isthmian S.S. Co., 359 U.S. 314, 319–20 (1959) (holding that setoffs are not payments); Citizens' Nat'l Bank v. Lineberger, 45 F.2d 522, 530 (4th Cir. 1930) ("A deposit of funds differs from a payment in the essential particular that it is withdrawable at the will of the depositor.").

happens when a secured creditor applies cash collateral to the underlying secured claim is that the debtor's valueless equity in the cash is extinguished (along with any junior security interests on the cash).[75] Receipt of cash proceeds automatically extinguishes the secured claim which encumbers the cash.

When it comes to collecting encumbered receivables, Article 9 never quite gets around to saying this. We learn from section 9-607(a) that "[i]f so agreed, and in any event after default, a secured party . . . (2) may take any proceeds."[76] Although often fastidious about definition, Article 9 never gets around to defining the word "take." Clearly what is intended by "take" is that, once the secured party "takes" cash proceeds, the secured party has 100 percent interest in the cash, and the debtor and junior claimants have none. Upon this "taking," the secured claim encumbering the case is *pro tanto* reduced.[77] Prior to this taking, the secured party already had a superior interest in the cash proceeds. "Taking" simply stands for the erasure of the debtor's valueless equity and erasure of any junior secured claims on the cash.

Properly, the creation of a security interest can never be defended under section 547(c)(2),[78] but there is at least one case that seems to hold otherwise. In *Kleven v. Household Bank F.S.B.*,[79] debtors (in a consolidated appeal) sold their income tax refunds to a bank. In this transaction, the debtors ordered the Internal Revenue Service to pay the bank. Although the transaction was called a "loan,"[80] it clearly was the sale of a "payment intangible,"[81] which, under Article 9, is a self-perfecting transaction.[82] Since there was a contemporaneous exchange of values, the transaction was not a *prima facie* voidable preference, and the court should not have considered defensive doctrines at all.[83] The *Kleven* court, however, became fascinated and transfixed by what is "ordinary." It found the "sale" to be an ordinary course "payment."[84] The court overlooked the fact that the case does not involve a *prima facie* avoidance of a transfer on antecedent debt. Revealingly, the court correctly noted that the bank had not manifested a setoff (chal-

75. Carlson, *Crucible*, *supra* note 30, at 272–75.

76. U.C.C. § 9-607(a) (2017).

77. *See id.* § 9-207(c)(2) ("a secured party having possession of collateral . . . shall apply money or funds received from the collateral to reduce the secured obligation, unless remitted to the debtor").

78. Tidwell v. Chrysler Credit Corp. (*In re* Blackburn), 90 B.R. 569 (Bankr. M.D. Ga. 1987); Carlson, *Crucible*, *supra* note 30, at 280.

79. 334 F.3d 638 (7th Cir. 2003).

80. A Refund Anticipation Loan, to be exact. *Id.* at 639.

81. "'Payment intangible' means a general intangible under which the account debtor's principal obligation is a monetary obligation." U.C.C. § 9-102(a)(61) (2017). "'Account debtor' means a person obligated on [a] general intangible." *Id.* § 9-102(a)(3). Therefore, the IRS is an account debtor that owes a payment intangible to the taxpayer.

82. *Id.* § 9-309(3).

83. The bank did argue that the "loan" was really the sale of a payment intangible (i.e., an "absolute assignment") and a perfected security interest. *Kleven*, 354 F.3d at 641. On security interests in tax refunds, see Carlson, *Crucible*, *supra* note 30, at 242; Howard Kern, Note, *The Voidablity of Security Interests in Tax Refunds Under Section 547 of the Bankruptcy Code*, 6 CARDOZO L. REV. 641, 641–63 (1985).

84. *Kleven*, 334 F.3d at 642–43.

lengeable under the "improvement of position" rule in section 553(b))[85] "because [the bank] held title to the funds when they were received at the bank and then transferred to the bank's own account."[86] If pre-ownership of the funds contradicts ownership by setoff, it also contradicts ownership by payment as well.

In this article, I will assume that *Kleven*'s application of the section 547(c)(2) defense to the sale of a payment intangible to be illegitimate. Properly, no defense was needed in *Kleven* because the transaction involved a contemporaneous exchange of values and so was never a *prima facie* preference.

3. Givebacks

The third defense we shall consider is the giveback of value after a voidable preference is received. The basic theme of this defense is that if a creditor receives a preference but later restores value to the debtor's estate, the voidable preference is forgiven.

Thus section 547(c)(4) first insists that the voidable preference occur first and the atonement occurs second. The theory of forgiveness is strictly Lutheran. No indulgences in advance of sin are permitted. For indulgences, creditors must look to section 547(c)(5), which defends floating liens on inventory and receivables.[87]

The defense exists to the extent that the creditor puts back new value to restore the debtor's estate.[88] Not all advances made by the creditor back to the debtor qualify for the section 547(c)(4) defense. For example, if a creditor has been paid on antecedent debt and then advances unsecured credit, the creditor qualifies for a defense because the unsecured loan reestablishes the status quo before the preference. If, on the other hand, the creditor subsequently advances *secured* credit, the debtor's estate is not restored. The secured advance does not defend the earlier voidable preference.[89] Or if new unsecured credit is extended but is then paid back, the advance does not ultimately restore the bankruptcy estate and so cannot serve as defensive material.[90]

4. Floating Liens on Receivables

The Bankruptcy Code recognizes a special problem for Article 9 security interests on inventory and receivables. These security interests tend to be transfers on antecedent debt that attach slightly before a bankruptcy petition.[91]

85. We will encounter section 553(b)'s governance of setoffs *infra* in the text accompanying notes 241–67.

86. 334 F.3d at 643.

87. As discussed *infra* in the text accompanying notes 19–106.

88. *In re* Prescott, 505 F.2d 719, 731 (7th Cir. 1986) ("[T]he theory behind the 'subsequent advance' exception . . . is that to the extent unsecured new value is given to the debtor after a preferential transfer is made, the preference is repaid to the bankruptcy estate.").

89. 11 U.S.C. § 547(c)(4)(A) (2012).

90. *Id.* § 547(c)(4)(B).

91. Carlson, *Crucible*, *supra* note 30, at 309–10.

Prior to the Bankruptcy Code, all manner of contortions were indulged to prevent wholesale avoidance of security interests on floating collateral.[92] Section 547(c)(5)[93] replaces these nonstatutory tricks and judicial *legers-de-mains* with a compromise. On the one hand, secured creditors are not punished for the purely floating nature of the collateral. On the other hand, undersecured creditors are punished if they improve their position over the preference period.

To institute this compromise, a complex formula in section 547(c)(5) examines two points in time to test whether the improvement of position occurred. The first (or forward) point in time is either the ninetieth day before bankruptcy[94] or the date on which "new value was first given under a security agreement creating the security interest.[95] The later of these two dates must be chosen. On the chosen date, we are to calculate "any amount by which the debt secured by such security interest exceeded the value of all security interests for such debt."[96] We then calculate a like amount on the day of the bankruptcy petition—the second or backward point in our two-point test.[97] If the insufficiency of collateral shrinks, the secured creditor has improved its position and, to that extent, the otherwise complete defense of section 547(c)(5) for floating liens on inventory or receivables is denied.

Significant for our present purpose is the fact that the Bankruptcy Code defines "receivable" very broadly as a "right to payment, whether or not such right has been earned by performance."[98] If a check is a "right to payment," then depositary banks claiming security interests on deposited items have a floating security interest entitled to the section 547(c)(5) defense, provided no improvement in position is achieved between the two temporal points described above.

A check issued by *E* to *D* can fairly be described as *D*'s right to payment from *E*. Suppose *E* issues a check drawn on *E Bank* payable to the order of *D*. The

92. On the pre-Code situation, see *id.* at 309–14.

93. According to section 547(c)(5):

> The trustee may not avoid under this section a transfer—
>
> (5) that creates a perfected security interest in inventory or a receivable or the proceeds of either, except to the extent that the aggregate of all such transfers to the transferee caused 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 . . . .

11 U.S.C. § 547(c)(5) (2012).

94. One year in case of insider creditors. *Id.* § 547(c)(5)(A)(ii).

95. *Id.* § 547(c)(5)(B).

96. *Id.* § 547(c) (preamble).

97. *Id.*

98. *Id.* § 547(a)(3).

check represents *E*'s undertaking to pay the instrument if *E Bank* elects to dishonor the check.[99] *D*'s right of payment from *E* is conditional until dishonor,[100] but either through honor or dishonor, *D*, by virtue of owning *E*'s check, has a right to payment and *E* has a duty to pay. Thus, *E*'s check is a receivable for purposes of section 547(c)(5).

Since the 2000 amendments to Article 9, *D Bank* is authorized to take super-priority[101] self-perfecting[102] security interest in the deposit account it maintains for *D*—provided *D* is not a consumer.[103] This is an oddity. A depositary bank taking such a security interest is both account debtor and creditor at the same time. A deposit account is *D*'s "right to payment"[104] *par excellence*. As a result, the section 547(c)(5) defense applies when *D Bank* takes a security interest in *D*'s account with *D Bank*.[105]

These points are potentially significant for *D Bank*, when *D Bank* extends unsecured overdraft credit to *D* by honoring *D*'s NSF[106] check.

III. The Depositary Bank and Voidable Preference Law

A. *Barnhill v. Johnson*

The case law concerning check clearing can be partitioned into three different scenarii. But ere we ponder them, I review the facts and holding of a definitive Supreme Court opinion, *Barnhill v. Johnson*.[107] The case only indirectly applies to the liability of a depositary bank in check-clearing cases, but is routinely consulted as the bubbling fount of check-clearing wisdom.[108]

Barnhill involved a creditor (William Barnhill), to whom the debtor issued a check on November 18. Barnhill probably deposited the check with his bank, which, as his agent, forwarded the item for payment.[109] The check was honored on November 20, which was the ninetieth day before bankruptcy.

The bankruptcy trustee sued Barnhill on the theory that payment was on November 20—within the preference period. Barnhill protested that the payment was on November 18, when the debtor issued the check. A payment

99. U.C.C. § 3-414(b) (2017).

100. *Id.* § 3-310(b) (if "an uncertified check is taken for an obligation, the obligation is suspended to the same extent the obligation would be discharged if an amount of money equal to the amount of the instrument were taken").

101. *Id.* § 9-327.

102. *Id.* §§ 9-104, 9-310(b)(8).

103. *Id.* § 9-109(d)(13) (Article 9 does not apply to "an assignment of a deposit account in a consumer transaction.").

104. 11 U.S.C. § 547(a)(3) (2012).

105. *See infra* text accompanying notes 206–31.

106. "Not sufficient funds." FTC v. Check's Investors, Inc., 502 F.3d 159, 162 (3d Cir. 2006).

107. 503 U.S. 393 (1992).

108. Sarachek v. Luana Savs. Bank (*In re* Agriprocessors, Inc.), 490 B.R. 852, 871 (Bankr. N.D. Iowa 2013).

109. The opinions in the case do not disclose whether a collecting bank or Barnhill himself presented the check. Probably we are dealing with a deposit by Barnhill with Barnhill's depositary bank.

ninety-two days before bankruptcy cannot be a voidable preference, where the creditor is not an insider.[110]

The Supreme Court determined that Barnhill was paid within the preference period. On the ninety-second day before bankruptcy, Barnhill had no right against the bank on which the check was drawn. "A check . . . does not of itself operate as an assignment of any funds in the hands of the drawee available for its payment, and the drawee is not liable on the instrument until he accepts it."[111] True, the debtor's obligation to Barnhill was "suspended" on November 20 by the delivery of the check.[112] But

> receipt of a check gives the recipient no right in the funds held by the bank on the drawer's account. Myriad events can intervene between delivery and presentment of the check that would result in the check being dishonored. The drawer could choose to close the account. A third party could obtain a lien against the account by garnishment or other proceeds. The bank might mistakenly refuse to honor the check.[113]

The exact time of payment was when the payor bank "had a right to 'charge' the debtor's account—i.e., the debtor's claim against the bank was reduced by the amount of the check—and [Barnhill] no longer had a claim against the debtor."[114]

The dissent, on the other hand, viewed the check as an unperfected payment. True, a sheriff might garnish the deposit account before presentment[115] of the check. That is what makes the payment unperfected.[116] Honoring the check thus constituted perfecting the payment. If accomplished within the grace period of section 547(e)(2)(A), the payment related back to issuance of the check. In further support of this view, one has to admit that the check is a piece of paper and that Barnhill, as holder, was the owner of that piece of paper. The paper yielded proceeds; classically, the payor bank took possession of the paper and sent it back to the debtor as a canceled check. One could conceive of this as a purchase of the paper that Barnhill "sold" to the depositary bank.[117] If so, the cash is proceeds of the piece of paper.

110. 11 U.S.C. § 547(b)(4) (2012).

111. U.C.C. 3-409(1) (2017).

112. *Id.* § 3-310(b).

113. *Barnhill*, 503 U.S. at 399. The court might well have added that the debtor could put a stop-payment order on the check, which the payor bank is obligated to follow. U.C.C. § 4-403(a) (2017).

114. *Barnhill*, 503 U.S. at 399–400.

115. U.C.C. § 3-501(a) (2017) ("'Presentment' means a demand made by or on behalf of a person entitled to enforce an instrument (i) to pay the instrument made to the drawee or a party obliged to pay the instrument or in the case of a note or accepted draft payable to a bank, to the bank . . . .").

116. *Barnhill*, 503 U.S. at 405 (Stephens, dissenting).

117. Superficially, the Check Clearing for the 21st Century (Check 21) Act, 12 U.S.C. §§ 5001–18 (Supp. V 2017), affects but does not alter this vision. Check 21 authorizes *D Bank* to send a picture of a physical check—a "substitute check," 12 C.F.R. §§ 229.1, 229.2(aaa) (2017)—to *E Bank*, in lieu of old-fashioned presentment of the physical check itself. *E Bank* then prints a facsimile of the check and, if it elects to honor the check, *E Bank* forwards the picture to *E* in lieu of the original check. Once paid, *D Bank* destroys the physical check. Stephanie Heller, *An Endangered Species: The Increasing Irrelevance of Article 4 of the UCC in an Electronics-Based Payments System*, 40 LOY. L.A. L. REV. 513, 529–37 (2006). Nevertheless, one might view *D Bank* as bailee of the physical thing that *E* has bought back from *D*.

Barnhill defines what "payment" means when checks are issued. On its own terms, the opinion is surprisingly trivial. In most cases, when a merchant takes a check for goods or services contemporaneously tendered, the transaction usually warrants the section 547(c)(1) defense of substantially contemporaneous exchange.[118] *Barnhill*, however, involved a creditor with an antecedent claim, where the check was issued outside of the preference period and the check was honored inside the period, and where the check was not in the ordinary course of the business or financial affairs of the debtor and creditor. Such cases, straddling the commencement of the voidable preference period, are surely rare.

Nevertheless, *Barnhill* wreaks havoc in any case where the check is issued before the bankruptcy petition and the check is honored after bankruptcy. In such cases, the merchant has received a postpetition payment that the trustee can avoid under section 549(a). This side effect is the main significance of *Barnhill*, and therefore the opinion can be considered unfortunate[119]—and unnecessary. Nevertheless the *Barnhill* rule much colors our analysis. Thus, payment occurs not when the check is issued but when it is honored.

If we take it seriously, *Barnhill*'s reasoning also rips the heart out of Article 4 of the U.C.C., as we shall see in due course, and constitutes a major reason why this decision should be rethought.[120]

B. Overdrafts

We will divide the check clearing cases into three mutually exclusive classes, in the manner of combinatorial algebra. The first category involves pure overdrafts, which are extensions of unsecured credit. It is here where the bank is most vulnerable. Pure overdrafts are to be distinguished from advances given on deposited items that have not yet been collected. Advances against provisional credits turn out to be secured loans and are less risky for the banks (provided the items on which the provisional credit is based are successfully collected). The case law, however, is confusing in that "overdraft" is used in both contexts. It is often hard to figure out from the case descriptions whether the bank has made an *unsecured* advance or a *secured* advance against provisional credits.

I shall refer to extensions of unsecured credit as "overdrafts." Advances against provisional credits are *not* overdrafts, as I have defined them. Our present concern is cases involving pure overdrafts. Draws against deposited items will be considered later.[121]

Banks often agree to give overdraft protection, either by contract or on a case-by-case basis or, on occasion, by pure accident. Suppose, on March 1, *D* writes a $90 check on *D Bank* at a time when the deposit account has a zero balance. On

118. *See* Jeanne L. Schroeder & David Gray Carlson, Three Against Two: On the Difference Between Property and Contract (unpublished) (on file with the author).

119. For criticism, see Paulette J. Delk, *Payments by Check as Voidable Preferences: The Impact of* Barnhill v. Johnson, 45 Me. L. Rev. 53 (1992); Schroeder & Carlson, *supra* note 118.

120. *See infra* text accompanying notes 332–39.

121. *See infra* text accompanying notes 281–409.

March 4, *D*'s check is presented to *D Bank*. *D Bank* is well within its rights to dishonor this check.[122] Suppose it decides to honor the check on March 5. *D* is now obligated to repay the $90 overdraft.[123] *D Bank* has become an unsecured creditor of *D*.

Imagine, on March 6, that *D* deposits a $100 check payable to *D* and drawn on *E Bank*. *D Bank* registers a provisional credit to *D*. Under *Barnhill*, *D Bank* has not yet been reimbursed by *D*. *E Bank* might yet dishonor the item when *D Bank* presents it.

On March 10, *E Bank* in fact honors the deposited check. This means that *D Bank* has received a final settlement directly or indirectly from *E Bank*.[124] Because *E Bank* has credited *D Bank*, *D Bank* must now "firm up" *D*'s $100 provisional credit of March 6.[125] *D* now may withdraw funds as of right. Suppose that, before any withdrawal occurs, *D Bank* eliminates *D*'s $90 overdraft obligation by applying the collected funds against the overdraft. *D Bank* is no longer a creditor of *D*. In fact, the opposite is true. *D Bank* is a debtor of *D* and owes *D* $10.

A key issue (overlooked by most courts) is whether the bank has been *paid* or whether the bank has *manifested a setoff*.[126] If the bank has been *paid*, then potentially the bank has received a voidable preference. If the bank has manifested a setoff, then voidable preference law becomes irrelevant. Setoffs are never voidable preferences. According to Bankruptcy Code section 553(a):

> Except as otherwise provided in this section and in sections 362 and 363 of this title, *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 . . . .[127]

---

122. U.C.C. § 4-402(a) (2017) ("a bank may dishonor an item that would create an overdraft unless it has agreed to pay the overdraft"); Orlich v. Rubio Sav. Bank, 38 N.W.2d 622, 624 (Iowa 1949) (the fact that bank paid overdrafts in the past did not require the bank to do so in the future).

123. U.C.C. § 4-401(a) (2017) ("A bank may charge against the account of a customer an item that is properly payable from the account even though the charge creates an overdraft.").

124. *Id.* § 4-215(a) ("An item is finally paid by a payor bank when the bank has first done any of the following: . . . (2) settled for the item without having a right to revoke the settlement under statute, clearing-house rule or agreement . . . .").

125. According to U.C.C. section 4-202(a)(3), a collecting bank must exercise ordinary care in "settling for an item when the bank receives final settlement." *D Bank* is "safe harbored" under this provision if it takes "proper action before its midnight deadline following receipt of [a] settlement." *Id.* § 4-202(b). The midnight deadline is "midnight on its next banking day following the banking day . . . from which the time for taking action commences to run." *Id.* § 4-104(a)(10); *see also id.* § 4-215(d) ("If a collecting bank receives a settlement for an item which is or becomes final . . . any provisional credit given for an item in the customer's account with its customer becomes final.").

126. "The right of setoff (also called 'offset') allows entities that owe each other money to apply their mutual debts against each other, thereby avoiding 'the absurdity of making *A* pay *B* when *B* pays *A*' . . . . [A] setoff has not occurred until three steps have been taken: (i) a decision to effectuate a setoff, (ii) some action accomplishing the setoff, and (iii) a recording of the setoff." Citizens Bank v. Strumpf, 516 U.S. 16, 18–19 (1995) (citation omitted). "Setoff" refers to mutual debts that arise out of different transactions. If a party has a right to offset a claim against a debt both of which arise out of the same transaction, such as a buyer's right to set off damages for breach of warranty against the seller's right to payment for goods sold, the party has a right of recoupment and not a setoff. N.Y. State Elec. & Gas Corp. v. McMahon (*In re* McMahon), 129 F.3d 93, 96 (2d Cir. 1997).

127. 11 U.S.C. § 553(a) (2012) (emphasis added).

The emphasized language makes clear that voidable preference law has no jurisdiction[128] as to the overdraft situation if *D Bank* proceeds by setoff.[129]

This jurisdictional conclusion is analyzed by Robert Laurence and Jill R. Jacoway in an unjustly neglected article published over twenty years ago.[130] Their finding has important statutory consequences. Payments and other transfers are potentially voidable under Bankruptcy Code section 547(b). Setoffs are not. It is error to apply voidable preference principles to a bank setoff. That being said, virtually *every* case involving genuine overdrafts assumes voidable preference law applies. Almost no court justifies its application of voidable preference law by expressly considering the distinction between setoffs and payments. Courts seem willing to apply voidable preference law *and* setoff law sequentially, giving the depositary bank two chances to lose.[131]

Given that the question is jurisdictional, how can we tell if *D Bank* has been *paid*? Or if *D Bank* (or *D*, who has a reciprocal right) has *manifested a setoff*?

"Payment" is a term that the Bankruptcy Code uses[132] but, as we have said, does not define. We have already proposed that a payment is *D*'s *voluntary* tender of cash or cash equivalents in satisfaction of an obligation. When we have a pure deposit of cash or checks, *D*'s act of depositing, without more, is ambiguous. It could mean that *D* wishes to "pay" the overdraft, or it could mean that *D* wishes to use the funds for future withdrawals.

The *Restatement (Second) of Contracts* section 259(1) addresses this ambiguity in a slightly different context:

> Except as stated in Subsections (2) and (3), if the debtor has not directed application of a payment between two or more matured debts, the payment is applied according to a manifestation of intention made within a reasonable time by the creditor to the debtor.[133]

---

128. For a case where the court analyzes deposited wire transfers sequentially as illegal setoffs and then as preferences, see *Pereira v. Summit Bank*, 94 Civ. 1565 (WHP), 2001 U.S. Dist. LEXIS 1712 (S.D.N.Y. Feb. 21, 2001). The case holds *D Bank* received deposits in violation of section 553(a)(3). Having done so the court should have held *D Bank* liable for the improper setoff. The court, however, violated our jurisdictional observation and continued on to acquit (wrongly) *D Bank* of voidable preference liability. On voidable preference liability in the case, see *infra* text accompanying notes 385–87. At the end of the day, *D Bank* paid nothing. The *Pereira* court must have viewed setoff as a *defense* against a voidable preference challenge, such that a violation of section 553(a)(3) cancels the defense. Apparently the court failed to grasp that section 553(a)(3) is an independent liability theory. If section 553(a)(3) was violated, *D Bank* was liable and the analysis was over; there was no need to analyze the case again under section 547(b).

129. Nevertheless, it has been held that pleading a claim under section 547(b) tolls the statute of limitations for a claim under section 553(b), since the anti-preference policy of these two provisions are similar. Sarachek v. Luana Sav. Bank (*In re* Agriprocessors, Inc.), 490 B.R. 852, 883–84 (Bankr. N.D. Iowa 2013); Pereira v. United Jersey Bank, N.A., 201 B.R. 644, 662 n.6 (S.D.N.Y. 1996).

130. Robert Laurence & Jill R. Jacoway, *The Application of Section 553 Set-Off Analysis to Pre-Bankruptcy Negative-Balance Checking Account Activity*, 12 Emory Bankr. Dev. J. 101 (1995).

131. *Pereira*, 2001 U.S. Dist. LEXIS 1712; Laws v. United Mo. Bank, N.A., 188 B.R. 263, 266 (W.D. Mo. 1995), *aff'd*, 98 F.3d 1047 (8th Cir. 1996), *cert. denied*, 520 U.S. 1168 (1997).

132. *E.g.*, 11 U.S.C. § 547(c)(2) (2012) (providing an ordinary course defense for "payments: to creditors that are otherwise avoidable").

133. Restatement (Second) of Contracts § 259(1) (1981). The exceptions do not apply to bank deposits.

This rule permits *D* to determine the meaning of a transfer but permits the creditor to supply the meaning where the debtor's intent is ambiguous.

The *Restatement* provision does not literally apply because we assume that *D* owes *D Bank* only one debt—the overdraft obligation. But the *Restatement* nevertheless gives intuitive guidance as to whether the deposit is a payment or whether the deposit is withdrawable as of right (subject at any time to later setoff).

Where *D* manifests an intent to pay or not to pay, we are to honor that act because tender of the deposit is *D*'s voluntary act, and *D* may determine what that act means. If *D* has manifested no intent, it is up to *D Bank* to decide whether a payment has occurred,[134] or whether the deposit sets up a setoff opportunity which may or may not be exercised in the future.[135] If *D Bank* intends to apply the deposit to the overdraft, *D Bank* must decide within a reasonable time[136] *and* must notify the debtor of this decision, by analogy to section 259(1) of the *Restatement*.[137]

D Bank may have the incentive to forego imposing the interpretation of "payment" in favor of "setoff." *D Bank* may be charging interest or fees for overdrafts.[138] If the setoff is delayed, interest continues to accrue. To prevent this from happening, *D* may have to intercede and eliminate the overdraft. In that case, *D* has not *paid* but has used *D*'s unilateral right to set off against the bank.

What would it take for *D Bank* to be *paid* (thereby terminating interest accrual on the overdraft)? Laurence and Jacoway[139] offer this example. Suppose, in addition to owing an overdraft debt, *D* has also signed a mortgage agreement calling for installment payments. *D* then writes a check *to D Bank* ordering *D Bank* to pay *D Bank*—known as an "on us" check.[140] In this case, *D Bank* is required to follow *D*'s instruction and to credit the mortgage debt. *D Bank* could not, for example, leave the mortgage agreement uncredited and instead use the "on us" check to reduce the overdraft. This follows from the rule that, when it comes to "payment," the payor's intent governs its meaning.[141]

134. N.J. Nat'l Bank v. Gutterman (*In re* Applied Logic Corp.), 576 F.2d 952, 962 (2d Cir. 1978) ("when either the depositor or the bank intends that a particular deposit may not be withdrawn but must be used to satisfy the bank's claim, the deposit does 'deplete the estate of the depositor' and constitutes a voidable preference *if the other requirements of § 60a are met*"); Goldstein v. Franklin Square Nat'l Bank, 107 F.2d 393, 394 (2d Cir. 1939) (deposits that are accepted "with intent to apply them on a pre-existing claim against the depositor rather than to hold them subject to the depositor's checks in the ordinary course are given their intended effect when so applied . . . are payments on account of debt"); RESTATEMENT (SECOND) OF CONTRACTS § 387(b) (1981) (creditor must manifest this intent within a reasonable time).

135. *D Bank* is not *required* to set off. Laurence & Janaway, *supra* note 130, at 111.

136. Cusick v. Second Nat'l Bank, 115 F.2d 150, 151–52 (D.C. Cir. 1940).

137. Miller v. Wells Fargo Bank Int'l Corp., 406 F. Supp. 452, 467 (S.D.N.Y. 1975) ("If the deposit is accepted by the bank with an intent to apply it 'on a pre-existing claim against the depositor rather than to hold [it] subject to the depositor's checks in ordinary course' . . . , the deposit is viewed legally as a transfer in payment of the debt. As such, it may be recovered by the trustee where the elements of a voidable preference are otherwise satisfied." (citation omitted)), *aff'd*, 540 F.2d 548 (2d Cir. 1976).

138. Laws v. United Mo. Bank of Kansas City, N.A., 98 F.3d 1047, 1049 (8th Cir. 1996), *cert. denied*, 520 U.S. 1168 (1997); Bernstein v. Alpha Assocs. (*In re* Frigitemp), 34 B.R. 1000, 1019 (S.D.N.Y. 1983), *aff'd*, 753 F.2d 230 (2d Cir. 1985).

139. Laurence & Janaway, *supra* note 130, at 112.

140. Jacobs v. State Bank (*In re* AppOnline.com, Inc.), 296 B.R. 602, 608 n.3 (Bankr. E.D.N.Y. 2003).

141. SAMUEL WILLISTON, A TREATISE ON THE LAW OF CONTRACTS 388–89 (Walter H. E. Yaeger ed. 1972).

But, vexingly, in *Studley v. Boylston National Bank*,[142] the Supreme Court treated an "on us" check as a setoff, not as a payment subject to voidable preference critique. In *Studley*, *D Bank* had received a series of promissory notes from *D* due at different times. Within the preference period, *D* paid several notes with an "on us" check and *D Bank* manifested a setoff with regard to the other notes. The trustee singled out the "on us" checks and claimed that these were preferential "payments." The court ruled that receipt of the "on us" check was a setoff and that setoffs could not be voidable preferences.[143]

Another factor that must be considered is that, especially after the 2000 amendments to Article 9, banks are encouraged to take security interests in the very deposit accounts they maintain for the debtor customers. When such a security interest exists,[144] there can never be a setoff. Rather, there can only be a foreclosure and so realization on deposits is always a foreclosure, to be analyzed under section 547(b).[145]

The conclusion that foreclosure of a security interest in a deposit account by *D Bank* is not a setoff is somewhat complicated by U.C.C. section 9-607 ("Collection and Enforcement By Secured Party"). Section 9-607(a)(4) authorizes *D Bank*, "if it holds a security interest in a deposit account perfected by control [to] apply the balance of the deposit account to the obligation secured by the deposit account."[146] This authorization sounds powerfully like *D Bank* is invited to manifest a setoff. Nevertheless, this action may be taken "[i]f so agreed, and in any event after default."[147] A setoff, in contrast, may occur in the absence of an agreement or a contractual default. Therefore, I assume that foreclosure under Article 9 of the U.C.C. is neither a setoff nor a nonconsensual payment, for the purpose of the Bankruptcy Code.

Account must be taken of U.C.C. section 9-340(b), which states that, with regard to a security interest in a deposit account maintained with the secured party, Article 9 "does not affect a right of recoupment or set-off of the secured party."[148] According to Comment 3 to that section, "[b]y holding a security interest in a deposit

142. 229 U.S. 523 (1913).

143. *Id.* at 529. Arguably the case is consistent with the interpretation that the "on us" checks *were* payments, but payments as to which *D Bank*, secured by the setoff right, obtained cash collateral. Receipt of cash collateral is never a voidable preference. But this anachronistically imposes the modern notion from Bankruptcy Code section 506(a) that *D Bank* is a secured creditor by virtue of its setoff right. According to Bankruptcy Code section 506(a):

> An allowed claim of a creditor . . . that is subject to setoff under section 553 . . . is a secured claim to the extent of . . . the amount subject to setoff . . . and is an unsecured claim to the extent that . . . the amount so subject to setoff is less than the amount of such allowed claim.

11 U.S.C. § 506(a) (2012). Even so, a payment to an *undersecured* creditor, in modern analysis, would still be voidable in whole or part. *See supra* text accompanying notes 45–57.

144. For instance, the Citibank N.A. client manual provides "You grant us a security interest in your account for amounts owing to us under this Agreement by any owner." CITIBANK N.A. CLIENT MANUAL 12 (effective June 1, 2017).

145. *In re* Prescott, 51 B.R. 751, 757 (Bankr. W.D. Wis. 1985), *aff'd*, 505 F.2d 719 (7th Cir. 1986). For a contrary view, see CLARK & CLARK, *supra* note 12, § 9.06, at 9–24.

146. U.C.C. § 9-607(a)(4) (2017).

147. *Id.* § 9-607 (preamble).

148. *Id.* § 9-340(b).

account, a bank does not impair any right of set-off it would otherwise enjoy."[149] This poses a challenge for interpreting the Bankruptcy Code, where the concept of setoff has a jurisdictional aspect: if we have a setoff right before us, the Bankruptcy Code does not affect it, except insofar as section 553 says otherwise. Therefore, I interpret U.C.C. section 9-340(b) to mean that if the secured party waives its security interest in the deposit account, the setoff right still exists underneath it all. But where the secured party applies cash proceeds to its claim pursuant to section 9-607(a)(4), it is not exercising a setoff, and so the voidable preference statute applies. Section 553 does not.[150]

If this is not so, Article 4 is undermined. Suppose *D* deposits *E*'s check and receives a provisional credit. *D Bank* then honors *D*'s check on the strength of the provisional credit. Under U.C.C. section 4-210(a), *D Bank* has a security interest in the *E* check that is contemporaneously exchanged for the advance of credit to *D*. When *D Bank* applies the proceeds of the *E* check to the advance of credit, *D Bank* has not received a voidable preference. But (potentially) *D Bank* has manifested a setoff that is voidable under section 553(b). If so, Article 4 is substantially compromised. We avoid this conclusion if Article 9 foreclosures are never setoffs. Accordingly, I assume (without much authority) that this is so.[151]

Because contracts with customers are routinely security agreements granting *D Bank* a security interest in *D*'s deposit account, setoffs in recent times are probably rare, and Article 9 foreclosure common. If this is right, the foreclosure must be judged under voidable preference law and never setoff law.

Because payment is possible, we first consider the law of extinguishing the overdraft by payment (not setoff). In the vast majority of reported cases, courts assume without discussion that the bank setoff is really a payment and then proceed to analyze the case under section 547(b), instead of the setoff provisions in section 553(a) and (b).

1. Payment

In our hypothetical, *D Bank* extended credit when it honored *D*'s check on March 5. On March 6, *D* deposited the *E* check and *D Bank* issued a provisional credit to *D*. On March 10, *E Bank* honored *D*'s presentment and *D*'s provisional credit became withdrawable as of right. Suppose on March 10, *D Bank* eliminates the overdraft by crediting the overdraft obligation with the amount of the final credit. We assume for the nonce that the March 10 transfer is a payment, not a setoff.

This payment is on antecedent debt. The overdraft arose on March 5. The payment occurred on March 10, when *D Bank* marked the overdraft obligation as

149. *Id.* § 9-340(b) cmt. 3.

150. Kleven v. Household Bank F.S.B., 334 F.3d 638, 643 (7th Cir. 2003) (realization on cash proceeds not a setoff). For a contrary view, see Marie T. Reilly, *What Goes Up Must Come Down: Check Kiting, the UCC, and the Trustee's Avoiding Powers*, 77 AM. BANKR. L.J. 333, 369–73 (2003).

151. The reason why taking cash proceeds of a valid security interest is never a voidable preference was discussed *supra* in the text accompanying notes 55–56. The workings of section 553(b) are discussed *infra* in the text accompanying notes 257–66.

extinguished. The trustee can establish a *prima facie* case of voidable preference against *D Bank*. *D Bank* received "payment" on antecedent debt.

In our hypothetical, *D Bank* advanced $90 on March 5. Bank error has arisen in the case law. Suppose *D Bank* erroneously records the advance as $85 instead of $90. The error is not discovered until after the bankruptcy petition is filed. Thus, putting aside the voidable preference theory, whereas the bankruptcy trustee thought she was heir to *D*'s $15 in credits withdrawable as of right, in truth the trustee inherited only $10 of such credits, once the error was corrected.

One would think that the error does not prejudice the trustee because the trustee may recover a $90 voidable preference, plus the $10 withdrawable as of right for a total amount of $100. In *Sarachek v. Luana Savings Bank (In re Agriprocessors, Inc.)*,[152] however, the court held that *D Bank*'s claim for the overdraft would be limited to $85. Therefore, the case denies that the full payment on antecedent debt ($90 in truth) is voidable. Rather, only payments on debt *as perceived by the bank* are voidable. This nonstatutory partial defense to voidable preference liability was based on the court's sense of equity: had both parties realized the debt was $90 (not $85), then it is probable—nearly certain!—that the parties would have acted differently for the duration of the preference period than they actually acted. According to the bankruptcy court in *Sarachek*:

> If the account balance were to be retroactively corrected, it is nearly certain that the parties would have acted differently based on a different, corrected balance. How they would have acted and how that would have affected that treatment of overdrafts differently is impossible to predict. [*D*] may have been required to deposit more money. [*D Bank*] may have returned many more checks . . . . Perhaps all of this would have brought on [*D*'s] bankruptcy much earlier—and even saved some creditors from the large losses they sustained. Because it is impossible to know the exact effect of these after the fact corrections on an account that the parties followed so closely, it is impossible to truly "correct" the whole case (*i.e.*, [*D Bank* and *D*] actions) for the posting errors that occurred.[153]

Thus the *Sarachek* court has invented a new "bank error" exception to voidable preference liability. In terms of our hypothetical, *D Bank* was liable for only $85, and the bankruptcy estate was reduced by $5.

The holding, however, makes no sense. On the day of the bankruptcy petition, *D Bank* thought the deposit account yielded $85 withdrawable as of right. According to the court of appeals, *D* "did not owe the posting-error amounts until [*D Bank*] corrected the statements."[154] If this is true, *D Bank*'s postpetition charge of $5 against the deposit account amounts to the setoff of a prepetition debt ($15) against a postpetition debt (the $5 correction). Such a setoff violates section 553(a), which limits valid setoffs to

152. 546 B.R. 811 (Bankr. N.D. Iowa 2015), *aff'd*, 547 B.R. 292 (N.D. Iowa 2016), *aff'd*, 859 F.3d 599, 605 (8th Cir. 2017).

153. *Id.* at 824. Notice the appeal to "probability" in a subjunctive what-if world of make-believe. Can one gamble in such a non-existent world?

154. 859 F.3d at 609.

> mutual debt owing by [*D Bank*] to [*D*] that arose before the commencement of the case under this title *against a claim of [D Bank*] against [*D*] that arose before the commencement of the case.[155]

On the emphasized language, *D Bank* had no setoff right. Accordingly, *D Bank* owed the full $15 to the bankruptcy estate pursuant to section 542(b):

> [A]n entity that owes a debt that is property of the estate and that is . . . payable on demand, or payable on order, shall pay such debt to, or on the order of, the trustee, except to the extent that such debt may be offset under section 553 of this title against a claim against the debtor.[156]

a. Givebacks

A depositary bank may well have permitted numerous overdrafts and may have received numerous preferential payments. For example, suppose *D Bank* offers four separate overdrafts just prior to the bankruptcy petition. Each time *D Bank* might feel that it has extended very little credit and, each time, was promptly paid back, thereby justifying the next overdraft credit extension. Each payback, however, was a *prima facie* voidable preference. Was such a banking practice safe?

The answer is yes (almost). In fact, *D Bank* has a series of section 547(c)(4) defenses. Imagine the following extensions of unsecured credit and paybacks, all within the preference period.

D	D Bank
1.	$90 credit extended
2. $90 repaid	
(*Prima facie* voidable but defended by 3.)	
3.	$90 new credit extended
4. $90 repaid	
(*Prima facie* voidable but partially defended by 5.)	
5.	$90 new credit extended
6. $100 deposited; $90 repaid	
(*Prima facie* voidable but totally defended by 7.)	
7.	$90 new credit extended,
8. $90 repaid	
(*Prima facie* voidable. Not defended.)	
9. Bankruptcy petition.	

Starting with #3, the odd-numbered credit extensions defend the even-numbered *prima facie* voidable preferences. Therefore, even though $360 in

155. 11 U.S.C. § 553(a) (2012) (emphasis added).
156. *Id.* § 542(b).

credit was extended, *D Bank* has only $90 of exposure. That is, repayment #8 was preferential and can be recovered. Because it is recovered, #7 constitutes new value that defends *prima facie* voidable preferences #1, #3, and #5 under section 547(c)(4).

With regard to defense #2 to voidable preference #1, can we say that the defense is valid even though the new value in #2 was repaid by the payment in #3? We may indeed. According to section 547(c)(4), *D Bank* is entitled to defense #3 because *D Bank* "gave new value [$90 in #3] to . . . the debtor (B) on account of which new value the debtor did not make an otherwise unavoidable transfer to . . . such creditor." That is, *D did* make a transfer to repay the #3 advance, but it was voidable, thereby making #3 eligible for a new value giveback.

In this sequence, each defensive item bears a dialectical relation with every other defensive item. Imagine the trustee claims that #2 is a preference because #3 was repaid by #4, and #3 is therefore not eligible as a giveback. *D Bank* therefore owes the trustee $90 for #2.

Now imagine the trustee claims that #4 is a voidable preference because #5 is not an eligible giveback because it was repaid by #6. The trustee has now contradicted herself. Earlier she asserted that #3 could not be a giveback because it was repaid. Now the trustee says the opposite. Because #4 was a voidable preference, #3 was a giveback. The trustee therefore loses her claim that #2 was a voidable preference. Now #4 is the voidable preference. Number 5 is not a give-back because it was repaid. So far, *D Bank* owes the trustee $90 for the #4 payment.

Now the trustee claims that the #6 $90 payment is a voidable preference, because the #7 overdraft is not a giveback. It was partially repaid by #8. But this contradicts the trustee's position with regard to voidable preference #4. The trustee loses the $90 cause of action in #4. Instead the trustee claims #6 is the voidable preference because the #7 overdraft is no giveback. *D Bank* owes $90 to the trustee.

The trustee now claims that the #8 payment is a voidable preference. Here *D Bank* has no defense. But the absence of a defense for #8 frees up the #7 overdraft as defensive material for the $90 payment in #6. Therefore, the trustee loses the #6 claim. But the trustee hangs on to the #8 claim for $90.

To summarize, the defenses for the #2, #4, #6 payments hold up. The trustee may not recover these payments, but the trustee has a clear claim to recover $90 for the #8 payment.[157]

In *Feltman v. City National Bank (In re Sophisticated Communications, Inc.)*,[158] *D* deposited items twenty-two times to reimburse twenty-two overdrafts. The court refused to avoid all the payments. "Instead, the Court determined that the Trustee's recovery would be limited to deposits curing the largest ledger balance over-

157. *In re* Prescott, 505 F.2d 719, 728 (7th Cir. 1986) (defense denied because *D Bank* did not carry its burden to show that overdrafts were never repaid).

158. 369 B.R. 689 (Bankr. S.D. Fla. 2007).

draft during the Applicable Time Period."[159] In other words, the overdraft for just one of the days in the preference period constituted a limit on the trustee's recovery. There seems to be no statutory justification for this. Each of the twenty-two reimbursements was a separate *prima facie* voidable preference.[160] But thanks to section 547(c)(4), the only voidable preference recoverable in *Sophisticated* was the last payment, regardless of its size. The standard is not the *greatest* overdraft but the *last* of them.

b. Contemporaneous Exchanges

Returning to our original hypothetical,[161] *D Bank* extended credit on March 5 and was reimbursed on March 10. *D Bank* cannot claim the benefit of the section 547(c)(1) defense. When *D Bank* extended overdraft credit on March 5, it hoped and expected that future deposits would eliminate the overdraft. It cannot be said, however, that *D Bank* and *D* intended a contemporaneous exchange—an extension of *secured* credit. Rather, *D Bank* extended *unsecured* credit on March 5 and was paid, *ex hypothesi*, on March 10. Thus, in *Sophisticated Communications*,[162] *D Bank* was denied the section 547(c)(1) defense, where in general *D Bank* depended on *D*'s unspecified deposits in the near future.

A slightly different sequence of events *does* engender the section 547(c)(1) defense. Amending our scenario, suppose *D*'s check is presented on March 4. Suppose *D Bank* contacts *D* on March 5, about the presentment. *D Bank* states that it will dishonor *D*'s check unless *D* deposits funds. *D* states that *D* can arrange for a wire transfer on March 6 from a specific deposit account that *D* maintains at *E Bank*. *D Bank* honors the check on March 5 in light of this expectation and receives the wire on March 6. The March 6 wire is a *prima facie* voidable preference, but is defended by section 547(c)(1). The parties intended that the debtor would wire funds in exchange for which the bank would honor the check that had generated

159. *Id.* at 695.

160. The *Sophisticated* court cited *Emerson v. Federal Savings Bank (In re Brown)*, 209 B.R. 874 (Bankr. W.D. Tenn. 1997), for this limitation. The reliance is problematic. First, in *Brown*, no true overdrafts existed and so everything the *Brown* court said is dictum. The *Brown* court then proceeded to describe the "greatest single day" formula followed in another case, *In re* Montgomery, 123 B.R. 801 (Bankr. M.D. Tenn. 1991), *aff'd*, 136 B.R. 727 (M.D. Tenn. 1992), *aff'd*, 983 F.2d 1389 (6th Cir. 1993). *Montgomery* was a check kiting case in which *D Bank* was held liable for receiving payments from victim banks. As we shall see, *Montgomery* was not a true overdraft case and the court wrongly ignored the fact that *D Bank* was a fully secured creditor. In short, *Brown* is poor authority for *Sophisticated*'s "single worst day" thesis.

161. According to this hypothetical:

March 1: *D* issues check.

March 4: Presentment to *D Bank*.

March 5: *D Bank* extends overdraft credit.

March 6: *D* deposits the *E* check.

March 10: *D Bank* collects the *E* check and is paid.

162. 369 B.R. 689 (Bankr. S.D. Fla. 2007).

the provisional debit. The wire did indeed arrive within hours of honoring the check which was "substantially contemporaneous."[163]

The distinction between the two cases is fundamental. In the first case, *D Bank* hoped for deposits. Basically, *D Bank* relied on *D*'s unsecured promise to convey assets in general. In the second case, *D Bank* consulted with *D* and received assurance that a *specific asset* would be conveyed on Wednesday. The second scenario is like *Dean v. Davis*.[164] The first one is not.

This distinction coheres with the analysis in *In re Chase & Sanborn Corp.*,[165] where section 547(b) or (c)(1) were not cited, in that the crucial events occurred more than ninety days before *D*'s bankruptcy petition.[166] The case involves the much different notion of fraudulent transfer. We shall, however, conform the case to our running hypothetical, in order to make a point about section 547(c)(1).

In *Chase*, *D Bank* received presentment of *D*'s check on March 4. On this day, the account balance was insufficient to cover the check. On March 5, *D Bank* consulted *D*, who indicated that a wire from *E Bank* would be sent on March 7. *D Bank* consulted with *E Bank* on March 5. *E Bank* confirmed the wire would be sent. The wire did indeed arrive on March 7. Bankruptcy soon ensued.

The trustee did not bring a voidable preference action against *D Bank*. Rather, the trustee alleged that the payee on *D*'s honored check was a gratuitous transferee who had received a fraudulent conveyance under Bankruptcy Code section 548(a). The trustee further alleged that *D Bank* was the "initial transferee" of the payee's fraudulent conveyance under Bankruptcy Code section 550(a). The trustee's theory was that the payee of the check had *not* received debtor property but had received *bank* property, and that *D Bank*, as initial transferee, had received the wire, which was debtor property. The wire, the trustee claimed, was the fraudulent transfer. The payee was therefore the "entity for whose benefit such transfer was made."

This analysis is all wrong. *D Bank* extended credit to *D* but, at *D*'s request, sent the loan proceeds to the fraudulent transferee. The fraudulent transferee received *D*'s loan proceeds, not *D Bank*'s property. Thus the fraudulent transferee was the initial transferee of *D*'s property (as of March 6). Later, *D Bank* was the transferee of quite separate *D* property—the March 7 wire transfer.

D Bank was therefore the initial transferee of a *prima facie* voidable preference from *D*. *D Bank* then received a wire transfer on March 7 on antecedent debt, making *D Bank prima facie* liable for a voidable preference. But *D Bank* could have invoked the section 547(c)(1) defense (if such a defense were needed). *D Bank* and *D* intended that honoring the check and receiving the wire be contemporaneous, and these two events were substantially so.

163. *Accord* Bernstein v. Alpha Assocs. (*In re* Frigitemp), 34 B.R. 1000, 1021 (S.D.N.Y. 1983), *aff'd*, 753 F.2d 230 (2d Cir. 1985) (pre-Code case).

164. 242 U.S. 438 (1917), *discussed at supra* text accompanying notes 64–70.

165. 848 F.2d 1196, 1197 (11th Cir. 1988).

166. *Id.* at 1198 (six months transpired between the payment and the bankruptcy petition), 1202 ("Under the particular facts in this case, the transaction does not fall within the provisions of the bankruptcy law on voidable transfers.").

The *Chase* court should have found no connection between the honoring of the check (a fraudulent transfer) and the later wire to *D Bank*. The payee of the check was the initial transferee of a fraudulent transfer. The property in question (*D Bank*'s loan to *D*) was the fraudulent transfer. The wire was not the fraudulent transfer. On our revised facts, according to which the wire was a *prima facie* voidable preference to the bank, the wire transfer was defended by section 547(c)(1).

Instead of proceeding along these lines, the court analyzed the case under the doctrine of "mere conduit."[167] This doctrine excuses banks from being considered the initial transferee of an avoidable transaction when the bank is a purely administrative intermediary between the debtor and the "real" transferee. In order to invoke the doctrine, however, it must be the case that the bank had no "control" over disposition of the funds. Fatal to the doctrine is a finding that the bank had lent funds to the debtor (by paying the payee of *D*'s check). If *D Bank* lent the funds, *D Bank* was in control over the funds lent (until the funds were actually advanced). The *Chase* court found no control in the case before it: "We do not believe that, in this situation, [*D Bank*] viewed itself as a creditor that had loaned over a million dollars to its customer."[168] In short, the *Chase* court ruled that, "under these facts, the ledger balance overdraft was not a debt."[169] Of course, it *was* a debt. If *D* had canceled the March 7 wire,[170] *D* would have owed *D Bank* for the March 6 overdraft.

The court's finding of "mere conduit" is just section 547(c)(1) analysis in different clothing. Recall that section 547(c)(1) is a codification of *Dean v. Davis*.[171] The case excused slight gaps between the creditor's extension of credit and the debtor's transfer when the debtor and the creditor never intended there to be an extension of unsecured credit. In *Chase*, the bank never intended to be an unsecured creditor. The parties intended a contemporaneous exchange and, even though technically there was a transfer on antecedent debt, the exchange was substantially contemporaneous, which is all section 547(c)(1) requires.

In contrast, the *Chase* "mere conduit" defense was denied in *Feltman v. City National Bank (In re Sophisticated Communications, Inc.)*,[172] where *D Bank* advanced an overdraft on the assurance that general deposits would be made the next day. In such a case, *D Bank* (the court ruled) intended to extend unsecured credit. As such the bank was not a "mere conduit," or in more statutory terms, was not eligible for the section 547(c)(1) "contemporaneous exchange" defense.

In distinguishing *Chase*, the *Sophisticated* court emphasized that the bank in *Chase* "knew with absolute certainty"[173] that a different bank would wire funds

167. *Id.* at 1197 (upholding the bankruptcy court's finding that the bank "was merely a commercial conduit of the funds"). On conduitry, see *Bonded Financial Services, Inc. v. European American Bank*, 838 F.2d 890 (7th Cir. 1988).

168. *Chase & Sanborn Corp.*, 848 F.2d at 1201.

169. Feltman v. City Nat'l Bank (*In re* Sophisticated Commc'ns, Inc.), 369 B.R. 689, 700 (Bankr. S.D. Fla. 2007).

170. U.C.C. § 4A-106 (2017).

171. 242 U.S. 438 (1917).

172. *Sophisticated Commc'ns*, 369 B.R. at 699.

173. *Id.* at 701.

(because the defendant bank had telephonic communication). "By contrast, [*D Bank* in *Sophisticated*] issued [to *D*] the cashier's checks . . . which created the ledger balance overdraft, on the mere promise that the Debtor would make deposits the next day to cover the overdraft."[174] That *D Bank* in *Chase* was "certain" to receive the wire is not a justified conclusion. *D* could have countermanded the payment order that generated the hoped-for wire.[175] Certainty in *Chase* did not exist. A sounder distinction is that, in *Chase* and *Dean*, a *specific asset* was designated for transmission (and was transmitted), whereas, in *Sophisticated*, *assets in general* were promised.[176]

A different sort of section 547(c)(1) claim was made in *Sarachek v. Luana Savings Bank (In re Agriprocessors, Inc.)*,[177] where the court denied summary judgment on the following theory: the very fact that overdrafts were permitted constitutes a new value that was substantially contemporaneous with payments received for past overdrafts. That is, overdraft protection *in general* was valuable and supposedly should count as the section 547(c)(1) defense. The court rejected this claim on the grounds that section 547(c)(1) requires an *intent* to exchange values, whereas the bank actually intended to extend unsecured credit and be repaid (hopefully) by nonspecific deposits a few days later.[178]

Hard *versus* soft value is a genuine issue in fraudulent transfer law, where the issue is much different from what is at stake under voidable preference law. Fraudulent transfer law tries to distinguish between a debtor's honest and dishonest behavior. It does not prohibit an insolvent debtor from taking "honest" risks. Thus, a debtor might buy a "service" by its conveyances. For example, a leveraged buyout, involving mortgages of corporate assets to a lender financing the buyout, might be defended on "soft values"—the mortgages purchase good management for the corporate debtor transferring the mortgages.[179] Thus, some courts find that intracorporate guarantees are not fraudulent transfers if the corporate structure has a business sense to it and therefore the factor of estate

174. *Id.*

175. U.C.C. § 4A-106 (2017).

176. A distinction in *Sophisticated* that does not function is this: In *Chase*, *D Bank* had received presentment of a check. Thereafter, the bank communicated with *E Bank*. *E Bank* confirmed that a wire transfer would be forthcoming from a specific bank account. But in *Sophisticated*, *D Bank* advanced funds by issuing cashier's checks, which *D Bank* could not later dishonor. The *Sophisticated* court found the distinction decisive. 369 B.R. at 701. The distinction, however, equates apples and oranges. Honoring *D*'s check in *Chase* equates with issuing the cashier's check to *D* in *Sophisticated*. *See* Farmers & Merch. State Bank v. W. Bank, 841 F.2d 1433 (9th Cir. 1987). These were the moments at which the advance was unequivocally given. The real difference was that in *Chase*, *D Bank* was told that a specific asset was headed its way. It did not intend to advance unsecured credit. In *Sophisticated*, *D Bank* relied on a promise to convey assets in general—not any specific asset.

177. 490 B.R. 852, 883 (Bankr. N.D. Iowa 2013).

178. Sarachek v. Luana Sav. Bank (*In re* Agriprocessors, Inc.), 546 B.R. 811, 829 (Bankr. N.D. Iowa 2015), *aff'd*, 547 B.R. 295 (N.D. Iowa 2016), *aff'd*, 859 F.3d 599 (8th Cir. 2017).

179. *See* David Gray Carlson, *Leveraged Buyouts in Bankruptcy*, 20 GA. L. REV. 73, 96–97 (1985) ("the nonfraudulent, insolvent LBO can be analogized to a service contract with a new management team, in the nature of a bonus paid in advance to a new chief executive officer by a company in trouble. The payment instantly impoverishes the debtor, but it improves credit in the long run if new management succeeds.").

diminution is relaxed.[180] Some courts, however, insist that fraudulent transfer law punishes anything that diminishes the bankruptcy estate.[181]

This controversy should not be transported into voidable preference law. Here the focus ought to be *solely* on diminution of the bankruptcy estate.[182] According to Dean Lawrence Ponoroff and Julie C. Ashby:

> With this shift in emphasis [on guilty creditor knowledge], contemporary preference law shrugged off the last of its historical ties to the concept of fraud and fraudulent conveyances. The essence of modern preference law is no longer in the preferring, but in the consequence of being preferred. This focus on preferential *effect*, rather than on subjective motive or intent, is a manifestation of the fact that, in defining a voidable preference, the drafters of the Code decided to give primacy to the policy of equality among creditors after insolvency as the central justification for preference law.[183]

Thus, if a quantifiable new value replaces value taken out, and if the exchange was intended to be contemporaneous, then the section 547(c)(1) defense can be invoked. But the observation that *D Bank*'s unsecured advances are a "service" and therefore should be the stuff of the section 547(c)(1) defense is little better than a general claim for bank privilege from voidable preference critique.

Finally, it is possible *D Bank* can make out an earmarking case—what I think is better expressed as a section 547(c)(1) defense. In *Macleod v. First National Bank (In re Sosebee Freight, Inc.)*,[184] *D* owed *D Bank* for an overdraft. *D* could not pay and so *S* (the shareholder of *D*) took out a secured loan from *D Bank*. *S* permitted *D Bank* to apply some of the loan proceeds to eliminate *D*'s overdraft. *S* looked for unsecured reimbursement by *D*. The court held that the earmarking concept applied.[185] Or, in statutory terms *D Bank* and *D* agreed that *S* would refinance *D Bank*'s unsecured claim. Although *D*'s granting of security to *S* would have been an impediment to this defense, *S*'s grant of security to *D Bank* was not. *S* advanced unsecured credit to *D* when it paid *D Bank* on behalf of *D*.[186] Hence section 547(c)(1) defended the *prima facie* voidable preference.

180. Telefest, Inc. v. VU-TV, Inc., 591 F. Supp. 1368 (D.N.J. 1984); *see generally* Jack F. Williams, *The Fallacies of Contemporary Fraudulent Transfer Models as Applied to Intercorporate Guaranties: Fraudulent Transfer Law as a Fuzzy System*, 15 CARDOZO L. REV. 1403 (1994).

181. Nordberg v. Sanchez (*In re* Chase & Sanborn Corp.), 813 F.2d 1177, 1181 (11th Cir. 1987) ("Fraudulent transfers are avoidable because they diminish the assets of the debtor to the detriment of all creditors."); Rubin v. Mfrs. Hanover Trust, 661 F.2d 979, 989 (2d Cir. 1981) ("Whatever the motivation, the fraudulent conveyance provisions . . . recognize that such transactions may operate as a constructive fraud upon the debtor's innocent creditors, for they deplete the debtor's estate . . . without bringing in property of similar value from which creditors' claims might be satisfied.").

182. *In re* Willaert, 944 F.2d 463, 464 (8th Cir. 1991) ("The fundamental purpose of section 547(b)'s avoidable preference provision is to restore the bankruptcy estate to its pre-preferential transfer condition.").

183. Lawrence Ponoroff & Julie C. Ashby, *Desperate Times and Desperate Measures: The Troubled State of the Ordinary Course of Business Defense—And What to Do About It*, 72 WASH. L. REV. 5, 12–13 (1997) (footnotes omitted); *see also* Lawrence Ponoroff, *Evil Intentions and an Irresolute Endorsement for Scientific Rationalism: Bankruptcy Preferences One More Time*, 1993 WIS. L. REV. 1439, 1449–50 [hereinafter Ponoroff, *Evil Intentions*] ("the determination of when a preference occurs can and should be made on the basis of objective criteria").

184. Case No. 01-42006, 2004 Bankr. LEXIS 2201 (Bankr. N.D. Ga. 2004).

185. *Id.* at *6–7.

186. *See supra* text accompanying notes 67–71.

c. Statutory Lien

A quite separate defense has never been addressed. In our running hypothetical, *D Bank* advanced $90 in unsecured overdraft credit, and, thereafter, *D* deposited a $100 item with *D Bank*. *D* was "paid" from the collection of the $100 item. Can *D Bank* claim that it has a security interest in the item by operation of U.C.C. section 4-210(a)? If the answer is yes, then *D Bank* can claim that its self-perfecting security interest in the $100 item is a "statutory lien" within the meaning of Bankruptcy Code section 101(53).[187] In that case, *D Bank* has a defense against voidable preference liability under section 547(c)(6)—the trustee may not avoid a transfer "that is the fixing of a statutory lien that is not avoidable under section 545."[188] If there is a valid statutory lien on the deposited items, receipt of proceeds from the statutory lien is not a preference on the theory that foreclosures of valid liens are never preferential.[189]

The defense of statutory lien does not work, but for a subtle reason. *D Bank* does *not* have a security interest in deposited items under U.C.C. section 4-210(a). According to that provision:

> A collecting bank[[190]] has a security interest in an item . . . or the proceeds of [it]
>
> (1) in case of an item deposited in an account, to the extent to which credit given for the item has been withdrawn or applied;
>
> (2) in case of an item for which it has given credit available for withdrawal as of right, to the extent of the credit given, whether or not the credit is drawn upon or there is a right of charge-back; or
>
> (3) if it makes an advance on or against the items.[191]

None of these provisions applies to the $100 item deposited on March 6. The March 5 advance was not a withdrawal against a provisional credit. The provisional credit did not exist until March 6. Ergo subsection (1) does not apply. Subsection (2) equally requires a preexisting provisional credit which has been

187. Some courts think so. First Tenn. Bank, N.A. v. Stevenson (*In re* Cannon), 237 F.3d 716, 720 (6th Cir. 2001) ("The security interest arose by operation of law."); Howell v. Bank of Newnan (*In re* Summit Fin. Servs., Inc.), 240 B.R. 105, 119 (Bankr. N.D. Ga. 1999) (bank security interest in items deposited "arose by operation of law"). According to Bankruptcy Code section 101(53), a statutory lien is a

> lien arising solely by force of a statute on specified circumstances or conditions, or lien of distress for rent, whether or not statutory, but does not include security interest or judicial lien, whether or not such interest or lien is provided by or is dependent on a statute and whether or not such interest or lien is made fully effective by statute.

11 U.S.C. § 101(53) (2012).

188. Statutory liens that are unperfected (as against subsequent bona fide purchaser of the collateral) are avoidable in bankruptcy. *Id.* § 545(2). Security interests under U.C.C. section 4-210(a), however, are self-perfecting. U.C.C. § 4-201(a)(3) (2017).

189. We chiseled in stone that foreclosure of valid liens is always protected by Bankruptcy Code section 547(b)(5)—the hypothetical liquidation test. *See supra* text accompanying note 57.

190. U.C.C. § 4-106(5) (2017) ("'Collecting bank' means a bank handling an item for collection except the payor bank.").

191. *Id.* § 4-210(a).

made withdrawable as of right before the items were collected. We do not have those facts here. Nor does (3) apply, since *D Bank* advanced no funds "against the items," which on March 4 had not yet been deposited. In short, no after-acquired property liens are permissible under section 4-210(a). Therefore, *D Bank* can claim no statutory lien.[192] Article 9 vastly favors after-acquired property clauses in security agreements.[193] Article 4 decidedly does not.

D Bank's agreement with *D* may make the deposit account itself collateral for any debt that *D* owes *D Bank*.[194] In such a case, once an item is deposited in the account *and collected*, *D Bank* has a security interest in the proceeds because the proceeds are part of the deposit account. But such a security interest arises from *agreement*.[195] A "security interest" is a "lien created by agreement."[196] "The term 'statutory lien' does not include security interest . . . ."[197]

Prior to collection, a security interest in the deposit account would not seem to cover deposited items because these items do not belong to *D Bank*. As to these items, *D Bank* is merely the collection agent. The items belong only to *D*.[198] Perhaps, however, the agreement between *D Bank* and *D* makes deposited items collateral for any advance *D Bank* might make. Such a security interest would attach to the items (as an after-acquired property security interest) prior to the collection of the items. In any case, any such after-acquired property lien is a security interest created by agreement and therefore cannot be a statutory lien.

If *D Bank* has a consensual security interest on the $100 item deposited on March 6, it was created after the unsecured debt arose on March 5. As such it is a voidable preference.[199] When *E Bank* pays the $100 item and *D Bank* receives the proceeds, the proceeds are received in satisfaction of antecedent debt. They are not exchanged for new value. New value "means . . . release by a transferee [*D Bank*] of property [the deposited items] previously transferred to such transferee [on March 5] in a transaction *which is neither void nor voidable by the debtor or the trustee*."[200] *D Bank* released a lien that *was* voidable. Thus *D Bank* received the March 10 cash to pay a March 5 debt. Accordingly, *D Bank* is liable for voidable preference.

192. Gen. Motors Acceptance Corp. v. Union Bank, 329 F.3d 594 (8th Cir. 2003) (no section 4-210(a) security interest attached to items deposited after advance on provisional credits was made). For cases that assume a section 4-210 lien exists to secure classic overdrafts with after-acquired items, see the following: Bowling Green, Inc. v. State Street Bank & Trust Co., 425 F.2d 81 (1st Cir. 1970); Bernstein v. Alpha Assocs. (*In re* Frigitemp), 34 B.R. 1000, 1015 (S.D.N.Y. 1983) ("When [*D Bank*], acting as [*D*'s] agent, took the December 13 check for collection and credited [*D*'s] account to reduce its existing overdraft, the bank automatically obtained a security interest in the negotiable instrument, which would be liquidated only when the provisional credit was covered either by final payment of the check or a debit to [*D*'s] account."), *aff'd*, 753 F.2d 230 (2d Cir. 1985).

193. U.C.C. § 9-204(a) (2017).

194. *See supra* text accompanying notes 92-107.

195. U.C.C. § 9-203(b)(3)(D) (2017).

196. 11 U.S.C. § 101(51) (2012).

197. *Id.* § 101(53).

198. U.C.C. § 4-201(a) (2017).

199. Feltman v. City Nat'l Bank (*In re* Sophisticated Commc'ns, Inc.), 369 B.R. 689, 699 n.3 (Bankr. S.D. Fla. 2007).

200. 11 U.S.C. § 547(a)(2) (2012) (emphasis added).

A shadowy subject is the so-called banker's lien. These exist under ancient common law and covered negotiable instruments under control of the bank.[201] Usually such liens are not statutory liens for the mere reason that no statute creates them. Bankruptcy Code section 101(53) insists that there be a statute, unless the lien is for rent on real property.[202] It seems as if a few states *do* have old statutes kicking around from the nineteenth century. Thus, section 3054(a) of the California Civil Code provides:

> A banker, or a savings and loan association, has a general lien, dependent on possession, upon all property in his or her hands belonging to a customer, for the balance due to the banker or savings and loan association from the customer in the course of the business.[203]

According to an Oklahoma statute, "A banker has a general lien, dependent on possession, upon all property in his hands belonging to a customer, for the balance due to him from such customer in the course of the business."[204] In such states, a bankruptcy trustee cannot recover the March 10 payment because the payment is proceeds of a "statutory" lien. Foreclosures of valid liens never engender voidable preference liability.

d. The Receivables Defense

A counterintuitive idea—as yet untested in the courts and introduced here for the first time—is that where *D Bank* takes an automatically perfected security interest in *D*'s deposit account maintained at *D Bank*, *D Bank* may be entitled to the section 547(c)(5) defense for overdraft repayments received shortly before bankruptcy.

It is now very common for banks to take security interests in the deposit account it maintains as a routine part of its agreement with its customer.[205] We have already seen that section 547(c)(5) protects perfected[206] security interests in receivables and that a receivable is very broadly defined as "right to payment."[207] This easily encompasses *D*'s deposit account.

In our hypothetical, *D Bank* extended unsecured credit ($90) on March 5. It received a deposit of a $100 item on March 6. *D Bank* collected the item on March 10 and was "paid." So far the trustee has a *prima facie* case of voidable preference. A section 547(c)(5) defense, however, may save the day for *D Bank*.

201. Annotation, *Lien of Bank Upon Commercial Paper Delivered to It by the Debtor for Collection*, 22 A.L.R.2d 478 (1948); Thomas G. Dobyns, Note, *Banking Setoff—A Study in Commercial Obsolecence*, 23 HASTINGS L.J. 1585, 1586–87 (1972).

202. 11 U.S.C. § 101(53) (2012) (a statutory lien is a "lien arising solely by force of a statute on specified circumstances or conditions, or lien of distress for rent, whether or not statutory").

203. CAL. CIV. CODE § 3054(a) (2016).

204. OKLA. STAT. tit. 42, § 32 (2017).

205. *See supra* text accompanying notes 91–107.

206. 11 U.S.C. § 547(c) (2012) ("The trustee may not avoid under this section a transfer—. . . (5) that creates a perfected security interest in . . . a receivable . . . .").

207. *Id.* § 547(a)(3).

Our first observation about the (c)(5) defense is that the opening words defend *D Bank* absolutely from voidable preference liability, to the extent *D Bank* is claiming a security interest on a "receivable." According to these opening words:

> 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 . . . .[208]

If the statute ended there, *D Bank* would prevail. But the phrase just quoted is potentially negated by a long and complicated "except" clause that is carefully designed to punish floating liens for any improvement of position gained over the life of the ninety-day preference period.

The "except" clause[209] establishes a "simple"[210] two-point test.[211] According to this test, we are to identify two points in time. At each point we are to calculate two "amounts." The amounts calculated differ for each of the two points in time we are to identify. If this "amount" was *reduced* between the two points in time, then, to the extent of the reduction, the "except" clause cancels out the complete defense proffered by the opening words of section 547(c)(5). On the other hand, if there is no reduction, the "except" clause implodes, and the happy secured creditor is left with the complete defense supplied by the opening words of section 547(c)(5).

As to the two points in time, there is a forward point and a backward point. The backward point is easy to identify. It is "the date of the filing of the petition."[212] For this point in time, we are to calculate the "the aggregate of all such transfers."[213] "Such transfers" refers to the creation of security interests in receivables. For our purposes, this means the deposit account itself and plausibly includes the March 5 deposit by *D* in the encumbered deposit account. We assume this to be true but will return to this point later.

In our example, *D* deposited the $100 item on March 6. We assume for the moment that the deposit was part of the deposit account in which *D Bank* had a security interest. As of April 1, *D Bank*'s claim against *D* was zero.

The backward point in time is trickier to locate. Continuing to assume that *D Bank* is not an insider of *D*, we are to choose

> 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 . . .

208. *Id.* § 547(c).

209. For the text of this clause, see *supra* note 93.

210. One commentator proclaims the "except" clause "a medieval instrument of torture." Richard F. Duncan, *Preferential Transfers, the Floating Lien, and Section 547(c)(5) of the Bankruptcy Reform Act*, 36 Ark. L. Rev. 1, 25 (1982); *but see* Barkley Clark, *Preferences Under the Old and New Bankruptcy Acts*, 12 U.C.C. L.J. 154, 178 (1979) ("The beauty of this rule is its simplicity, assuming that valuation is not too difficult to prove.").

211. For an algebraic account of how this test works, see Carlson, *Crucible*, *supra* note 30, at 309–43.

212. 11 U.S.C. § 547(c)(5).

213. *Id.*

> (B) the *date on which new value was first given under the security agreement creating such security interest* . . . .[214]

Let us take the simplest application of this language. Since in our hypothetical, the bankruptcy petition was filed on April 1, January 1 is the ninetieth day before bankruptcy and is the start of the preference period. Suppose the choice of section 547(c)(5)(A)(i) is appropriate. Then we are to examine the records for January 1. If we find on that day there was *no overdraft outstanding*, then the "amount by which the debt secured by such security interest exceeded the value of all security interests for such debt"[215] is calculated at zero. This is great news for *D Bank*. Since we search for a *reduction* in the above "amount" caused by the "aggregate of transfers" over the preference period, a zero result for the January "amount" portends *no reduction* over the preference period.[216] As a result, the "except" clause does not apply. *D Bank* is entitled to a complete defense for the March 10 payment, even though that March 10 payment eliminated an unsecured overdraft advance made on March 5.[217]

In order for the January 1 date to stand, it must be true that (1) *D Bank* and *D* signed their customer agreement prior to January 1 and (2) at least one overdraft occurred before January 1. Let us suppose an overdraft occurred for the first time on December 1, paid back by deposits on December 2. December 1 therefore constitutes "the date on which new value was first given under the security agreement creating such security interest."[218] Since January 1 (the ninetieth day before bankruptcy) is later than the preceding December 1, we choose January 1 as the forward measuring time. If on January 1 there was no overdraft, *D Bank* has a complete defense.

Suppose, on the other hand, that *D Bank* had never before given overdraft credit. Rather, the $90 overdraft of March 5 was the very first time *D* was overdrawn. In that case, March 5 is "the date on which new value was first given under the security agreement creating such security interest."[219] Since March 5 is later than January 1, March 5 becomes the measuring date. On this day, the "amount by which the debt secured by such security interest exceeded the value of all security interests for such debt"[220] was $90. Since this amount was reduced by subsequent transfers, the "except" clause negates the entire section 547(c)(5) defense and *D Bank* must pay. It is arbitrary that *D Bank* wins if there was a December overdraft and *D*

214. *Id.* (emphasis added).

215. *Id.*

216. H.R. REP. NO. 595, at 216 (1978).

217. On the other hand, suppose even a larger overdraft existed (say $400) on January 1 compared to the $90 overdraft on March 5 (paid on March 10). Then the "amount by which the debt ($400) secured by such security interest (0) exceeded the value of all security interests for such debt" is $400. That is, on January 1 there was an overdraft that was eliminated some time after January 1—say by deposits on January 2. A second overdraft occurred on March 5, which was eliminated on March 10. The overall liability is $400 (not $490) because $400 constitutes the reduction between January 1 and April 1.

218. 11 U.S.C. § 547(c)(5)(B).

219. *Id.*

220. *Id.*

Bank loses if March 5 was the first overdraft. Arbitrariness is the price of the "compromise" of adopting the two-point test.

This analysis too quickly passed over a key issue. Earlier I opined that if January 1 is the proper choice for the forward measuring point and if there was no overdraft that day, there was no improvement in position and *D Bank* had a complete defense. I assumed that the deposit of the $100 item on March 5 was encumbered by *D Bank*'s security interest in the deposit account. In other words, I assumed that the $100 was part of the deposit account as of March 5.

There is another way of looking at the matter. *D* deposited the $100 item on March 6. *D* was the absolute owner of the item, even after the deposit. *D Bank* arguably had no security interest in the item, because the item was an instrument and the instrument is *not* the same as the deposit account itself.[221] If this is so, then *D Bank* collected the item from *E Bank* and kept the proceeds. The proceeds never reached *D*'s account. Accordingly, *D Bank* did not obtain a "receivable" from *D*. It received a payment of unencumbered cash. Section 547(c)(5) only defends transfers of *receivables*. Although a check is a receivable, *D Bank* never had a security interest in the check, and so section 547(c)(5) does not apply to the March 10 payment.

To further confuse matters, suppose *D Bank* actually firmed up *D*'s provisional credit on March 10 and then declared the deposit account debited for $90 on March 11. The $90 became part of the account. *D Bank* had a security interest in the account. *D Bank*'s reduction of the overdraft obligation is not a setoff because *D Bank* was foreclosing on the security interest pursuant to Part 6 of Article 9.[222] Now *D Bank* has the section 547(c)(5) defense. This too is highly arbitrary. *D Bank* wins on a certain bookkeeping strategy and loses on another.

Earlier I referred to "banker's liens."[223] Rarely were these "statutory liens" because they usually (though not always) were common law creations. Does the nonstatutory banking lien now comes to the rescue? On March 6, *D Bank* received a nonconsensual lien on the item *D* deposited. This lien attaches to a "receivable"[224] because, we opined, a check represents a right to payment. Alas, the banker's lien provides no assistance. Section 547(c)(5) defends "security interests" in receivables.[225] "The term 'security interest' means liens created by an agreement."[226] The banker's lien is no "security interest" because it is not created by agreement.

221. Article 9 defines a deposit account as "a demand, time, savings, passbook, or similar account maintained with a bank. The term does not include . . . accounts evidenced by an instrument." U.C.C. § 9-101(a)(29) (2017). An "account evidenced by an instrument" implies a certificate of deposit. The $100 check issued by *E* does not evidence the whole account but is just a deposit in the account.

222. We earlier said that setoffs and foreclosures are mutually exclusive categories. *See supra* text accompanying notes 243–68.

223. *See supra* text accompanying notes 202–05.

224. 11 U.S.C. § 547(c)(3) (2012).

225. *Id.* § 547(c)(5) ("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 . . . ." (emphasis added)).

226. *Id.* § 101(51).

On the other hand, if *D Bank* has a *consensual* security interest on deposited items which is separate and apart from the security interest in the deposit account itself, *D Bank* would appear to be fully eligible for the (c)(5) defense, which is a complete defense if no overdraft was outstanding on January 1. Transactional lawyers should take note!

Finally, a metaphysical assumption should be rendered explicit. Is a deposit account just *one* receivable or is it *many* receivables? Like the presocratic philosophers, we must contemplate the one and the many.[227]

Our discussion assumes that the deposit account is in fact *many* receivables. Thus, every deposit generates a separate obligation of *D Bank* to pay.[228] Otherwise, if the bank account were a single thing, it would be impossible to discern any improvement in position over the preference period. *D Bank* would have a defended security interest on just one thing, even if that thing greatly expanded in size over the preference period.[229] Because the policy of section 547(c)(5) is to punish improvement of position over the preference period, it must be the case that every bank deposit is a separate receivable that is separately encumbered by *D Bank*'s security interest.[230]

e. The Ordinary Course Defense

D Bank may be able to claim the ordinary course payment defense under section 547(c)(2). This section makes clear that the *debt* must be incurred in the ordinary course of business.[231] Separately the *payment* must be either "(a) made in the ordinary course of business or financial affairs of the debtor and transferee; or (b) made according to ordinary business terms."[232] Thus, in our running hypothetical, if *D Bank* customarily covered overdrafts, if *D Bank* was on "automatic pilot" in accepting the March 6 deposit, and if the bank did not use pressure or politics to obtain these deposits, the bank may well have a defense.[233]

227. *See* MICHAEL C. STOKES, ONE AND MANY IN PRESOCRATIC PHILOSOPHY (1971).

228. Thomas E. Plank, *Security Interests in Deposit Accounts, Securities Accounts and Commodity Accounts: Clarifying Article 9's Conceptual Confusion*, 69 OKLA. L. REV. 337, 347–56, 356–57 (2017).

229. Ray D. Henson, *"Proceeds" Under the Uniform Commercial Code*, 65 COLUM. L. REV. 232, 233 (1965).

230. *See* 11 U.S.C. § 547(e)(3) (2012) ("For the purposes of this section, a transfer is not made until the debtor has acquired rights in the property transferred.").

231. The defense requires that "such transfer was in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor." *Id.* § 547(c)(1). The assumption is that "ordinary course" modifies "debt." Sarachek v. Luana Sav. Bank (*In re* Agriprocessors, Inc.), 859 F.3d 599, 607–08 (8th Cir. 2017); Cox v. Momar Inc. (*In re* Affiliated Foods Sw. Inc.), 750 F.3d 714, 718 (8th Cir. 2014). "[B]ecause the statute refers to 'of the debtor and the transferee' and not 'between the debtor and the transferee,' even first time transactions can qualify for exception under the statute." Ponoroff, *Recalcitrant Passenger*, *supra* note 72, at 357 n.137 (citing Jubber v. SMC Elec. Prods., Inc. (*In re* C.E. Mining, Inc.), 798 F.3d 983 (10th Cir. 2015)); *see* Kotliar, *supra* note 68, at 231–33.

232. 11 U.S.C. § 547(c)(2) (2012).

233. There is a lively controversy over whether section 547(c)(2) permits an overweening creditor to point out that, even though collection was *subjectively* outside the ordinary course of business of financial affairs of the particular debtor and creditor, nevertheless the collection was *objectively* ac-

On the other hand, if *D Bank* is fully aware of *D*'s financial crisis and *D Bank* accepted deposits knowing that the effect of the deposits would be eventual "payment," then perhaps *D Bank*'s actions are "out of the ordinary course," and the defense is spoiled. It is impossible to state in advance what a finder of fact will consider to be ordinary or not ordinary.[234]

In *Feltman v. City National Bank (In re Sophisticated Communications, Inc.)*,[235] *D Bank* failed to qualify for the section 547(c)(2) defense. *D Bank* had issued cashier's checks[236] as the mode of advancing funds. The court focused on whether the mode of the advance was in the ordinary course of business or financial affairs of *D* and *D Bank*. Because the testimony of a bank officer was unspecific, the court ruled that *D Bank* had failed to carry its burden of proof establishing the defense.[237]

In *Sarachek v. Luana Savings Bank (In re Agriprocessors, Inc.)*,[238] *D Bank* allowed overdrafts on an "exceptional, not ordinary"[239] basis. As a result, the defense, after trial, was denied.

If a "payment" has occurred in the ordinary course of business of financial affairs of the debtor and of the bank, the bank has the section 547(c)(2) defense. But the bank may have taken an after-acquired property lien in all of *D*'s items in possession of *D Bank*. If we read section 547(c)(2) literally, as the Supreme Court would have us do, the security interest deprives *D Bank* of the section 547(c)(2) defense, even when the deposit is "ordinary." According to section 547(c)(2), the bank has a defense "to the extent that such [*prima facie* voidable preference] was in *payment* of a debt." What we have here, when there is a consensually created lien on the item deposited on March 6, is the attachment of a security interest, coupled with a realization on that security interest. The bank has not been *paid*. Rather it has *foreclosed* on its security interest pursuant to U.C.C. section 9-610(a). This conclusion is based on the view that "payment" means the debtor's voluntary conveyance of legal tender in satisfaction of an obligation.[240] Realization on collateral is not subject to the will of *D* and is not a payment, as we have defined it.

We have mentioned the banker's lien on negotiable instruments in *D Bank*'s possession. First we opined that typically the banker's lien is not a statutory lien. Then we opined that the banker's lien does not help *D Bank* in obtaining the section 547(c)(5) defense.[241] Now for a negative consequence of the banker's

cording to ordinary business terms, within the meaning of section 547(c)(2)(B). Subparagraph (B) was added in the 2005 amendments to the Bankruptcy Code. On the meaning of these amendments, see Kotliar, *supra* note 68; Ponoroff, *Recalcitrant Passengers*, *supra* note 72.

234. *See* Am. Bankr. Inst. Task Force on Preferences, ABI Preference Survey Report 23 (1997) ("no one knew what it means, and, not surprisingly in light of that perception, that application of the defense is inconsistent").

235. 369 B.R. 689, 699 (Bankr. S.D. Fla. 2007).

236. U.C.C. § 3-104(g) (2017) ("'Cashier's check' means a draft with respect to which the drawer and drawee are the same bank or branches of the same bank.").

237. 11 U.S.C. § 547(g) (2012) (imposing burden of proving defenses on the creditor).

238. 546 B.R. 811 (Bankr. N.D. Iowa 2015), *aff'd*, 547 B.R. 295 (N.D. Iowa 2016), *aff'd*, 859 F.3d 599 (8th Cir. 2017).

239. *Id.* at 833.

240. *See supra* text accompanying notes 73–86.

241. *See supra* text accompanying notes 202–05, 224–27.

lien! If *D Bank* has a banker's lien on March 6 for the deposited item, then it is foreclosing a security interest and is not being "paid" within the meaning of section 547(c)(2). Therefore, the presence of the banker's lien positively negates the "ordinary course" defense, when *D Bank* reimburses itself by collecting the March 6 deposited item.

2. Setoff

In the last section, we assumed on March 10 that the bank was "paid." As a result, *D Bank* was *prima facie* liable for receipt of a voidable preference.

Under the scenario we now consider, neither *D* nor *D Bank* has intended for the deposited March 6 item to be payment or a securing of payment of the overdraft. Rather, the parties intended a deposit to be withdrawable as of right, but subject to *D Bank*'s right of setoff. If, later, *D Bank* elects to set off, we do not have a payment. We have a manifested setoff and, accordingly, section 547(b) has no jurisdiction over the case.

The interaction of voidable preference law and setoffs has a vexatious history. Roughly speaking, the Bankruptcy Act of 1898 made preferences voidable on largely the same basis as today.[242] But section 68(a) provided that, in the bankruptcy proceeding, mutual debts should be "set off against [one] another, and the balance only shall be allowed or paid."[243] Setoffs were disallowed to the extent that the creditor took an assignment of an unsecured claim within four months of bankruptcy (or after bankruptcy) if the assignment was with knowledge of the debtor's insolvency.[244] The Bankruptcy Act also included section 57g: "The claims of creditors who have received preferences shall not be allowed unless such creditors surrender the preferences."[245]

In *New York County National Bank v. Massey*,[246] *D*, heavily in debt to *D Bank*, deposited funds with *D Bank* four days before bankruptcy. *D Bank* booked the deposit as withdrawable as of right. After *D* was bankrupt, *D Bank* submitted a proof of claim with the amount of the deposit deducted. The trustee responded that *D Bank*'s claim was disallowed by section 57g because the deposit was preferential. The Supreme Court ruled that the deposit was not a payment on antecedent debt and therefore not a preference, even though it recognized that

242. According to Bankruptcy Act section 60(a), as originally promulgated, "A person shall be deemed to have given a preference if being insolvent he has . . . made a transfer of any of his property, and the effect of the . . . transfer will be to enable any one of his creditors to obtain a greater percentage of his debt than any other such creditors of the same class." Bankruptcy Act of 1898 § 60(a). Later, a mental element was added: The trustee had to prove that the debtor knew or should have known that the effect of the transfer was preferential. This mental element was eliminated by the Bankruptcy Code but partially reinstated in the form of the section 547(c)(2) defense concerning ordinary course payments. *See* Ponoroff, *Evil Intentions*, *supra* note 182, at 1449–50.

243. Bankruptcy Act of 1898 § 68(a).

244. This provision is now codified (with a ninety-day period) in Bankruptcy Code section 553(a)(2).

245. An expanded version of this rule modernly can be found in 11 U.S.C. § 502(d) (2012).

246. 192 U.S. 138 (1904).

D Bank was "preferred" over other unsecured creditors.[247] Thus, *D Bank* was permitted a postpetition setoff of the deposit against its prepetition claim.

In *Studley v. Boylston National Bank*,[248] the Supreme Court extended this protection to a manifested prepetition setoff.[249] We have already noted that three of the setoffs were payments by "on us" checks.[250] The court did not distinguish the "on us" checks from the regular setoffs. Thus, prior to the Bankruptcy Code, deposits within the preference period that improved *D Bank*'s position were not preferences when later confiscated through setoff.

Studley yields the following sneaky ploy: if payment of an antecedent debt were instead styled a "loan" to the creditor which could, shortly after it was extended, be set off, voidable preference law would not apply.[251] Accordingly, Congress, in the Bankruptcy Code of 1978, greatly expanded the notion of the invalid setoff. Today that concept, as it affects depositary banks, is embodied in Bankruptcy Code section § 552(a)(3) and (b).[252]

The preamble to section 553(a) upholds the setoff right of *D Bank:*

> "[T]his title does not affect the right of a creditor to offset a mutual debt owing by such creditor to the debtor that arose before the commencement of the case . . . against a claim of such creditor against the debtor that arose before the commencement of the case.[253]

247. *Id.* at 148 ("in a sense the bank is permitted to obtain a greater percentage of its claim against the bankrupt than other creditors of the same class, but this indirect result is not brought about by the transfer of property within the meaning of the law").

248. 229 U.S. 523, 529 (1913).

249. *Id.* at 528–29 ("But there is nothing in § 68a which prevents the parties from voluntarily doing, before the petition is filed, what the law itself requires to be done after proceedings in bankruptcy are instituted.").

250. *See supra* text accompanying notes 142–43.

251. *See* James A. McLaughlin, *Amendment of the Bankruptcy Act* (Pt. 2), 40 HARV. L. REV. 583, 600–01 (1927) ("Unless this provision is enacted . . . , a creditor of the bankrupt believing that a payment of his claim would probably constitute a preference can avoid the law of preference by taking a loan instead of payment. That is far too simple an evasion of the law. And yet it seems to be countenanced in practically this crude form when a bank is such a creditor.").

252. "Therefore, *Massey* has become an anachronism." Meoli v. Huntington Nat'l Bank (*In re* Teleservices Grp., Inc.), 469 B.R. 713, 746 (Bankr. W.D. Mich. 2012), *rev'd on other grounds*, 848 F.3d 716 (6th Cir. 2017).

253. There are exceptions to this principle that are not pertinent to our analysis of voidable preference law. The above immunization of the setoff right is made subject to what is "otherwise provided . . . in section 362 and 363."

Section 362 is the automatic stay provision, and we learn in section 362(a)(7) that a bank is automatically stayed from manifesting a setoff in the postpetition period. This is not much of an impediment for *D Bank*. First, the bank is considered a secured creditor to the extent of its countervailing claim against its bankrupt customer—the stuff of the setoff right. 11 U.S.C. § 506(a) (2012). This countervailing claim against the customer is the bank's cash collateral. *Id.* § 363(a) ("In this section, 'cash collateral' means . . . deposit accounts . . . in which the [bankruptcy] estate and an entity other than the estate have an interest . . . ."). This the trustee may not use under section 363(c)(2) unless the bank consents or the court gives permission. Court permission in turn is conditioned on the trustee tendering to the bank "adequate protection" of its cash collateral. *Id.* § 363(p)(1). Second, the court in *Citizens Bank v. Strumpf*, 516 U.S. 16 (1995), authorized the bank to place a temporary freeze in order to have the stay lifted, so that the setoff can be manifested. In a reorganization case, the trustee or debtor-in-possession might defeat the bank's motion to lift the stay if the cash collateral is necessary

Pertinent to our focus on voidable preferences are two exceptions. First, according to Bankruptcy Code section 553(a)(3), the preamble does not protect the setoff right if

> (3) the debt owed to the debtor by such creditor was incurred by such creditor—
>
> (A) 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 set against the debtor . . . .[254]

This provision prevents a creditor wishing to be paid from "borrowing" the payment and then setting off free and clear of preference regulation.

In our case, *D Bank*'s debt to *D* is the credit of $100 withdrawable as of right on March 10 and as against which *D Bank* claims $90 for the overdraft. If this $100 debt was incurred for the *purpose* of generating the setoff right, then the setoff can be avoided, and the bank can be made to disgorge $90 to the bankruptcy trustee.[255] In effect, this possibility aligns with voidable preference coverage in the case where the deposits are out of the ordinary course of the debtor's business.[256]

The other provision that applies to *D Bank*'s March 10 setoff is section 553(b)(1):

> [I]f a creditor offsets . . . 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 the 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.[257]

for an effective reorganization. 11 U.S.C. § 362(d)(2)(B) (2012). But this implies that the bank has been adequately protected for the value of its cash collateral.

254. 11 U.S.C. § 553(a)(3) (2012).

255. Pereira v. Summit Bank, 94 Civ. 1565 (WHP), 2001 U.S. Dist. LEXIS 1712, at *28–33 (S.D.N.Y. Feb. 21, 2001).

256. One exotic possibility for avoiding this conclusion arises where the bank owes its customer on a certificate of deposit. For example, there has been an overdraft on March 4 and a deposit on March 5. On March 10 the bank leaves the checking account alone but declares that a separate certificate of deposit is set off. In that case, the bank and its customer are involved in a "securities contract," which is defined in Bankruptcy Code section 741(a)(7) as "a contract for the purchase of . . . a certificate of deposit." 11 U.S.C. § 741(a)(7) (2012). Section 555 states that

> [t]he exercise of a contractual right of a . . . financial institution . . . to cause the liquidation . . . of a securities contract, as defined in section 741 of this title, because of a condition of the kind specified in section 365(e)(1) . . . shall not be stayed, avoided, or otherwise limited by operation of any provision in this title.

Id. § 555. Banks are "financial institutions" under section 101(22). The setoff, however, would have to be motivated by a condition described in section 365(e)(1), which includes a right *in the contract* to set off the certificate of deposit because *D* is insolvent.

257. *Id.* § 553(b)(1).

This provision applies only if the setoff is actually manifested prior to bankruptcy (as it was in our hypothetical). The provision is designed to prevent an improvement in position across the ninety days prior to bankruptcy. One must identify two times. The first time is the later of ninety days[258] before bankruptcy and "the first date . . . on which there is an insufficiency." An insufficiency is "the amount, if any, by which a claim against the debtor exceeds a mutual debt owing to the debtor by the holder of such a claim."[259]

Applying this provision to our facts, we need to know whether the March 5 deficiency is the *first* such insufficiency after January 1. Suppose within the ninety days before there have been a series of overdrafts, each liquidated through deposits following thereupon. Only the first of these insufficiencies applies. Thus, whether this first insufficiency is larger or smaller than the March 5 insufficiency, it constitutes the measure of the trustee's recovery. In vernacular terms, an insufficiency is when *D Bank* is "in the red."

If *D Bank* never manifests the setoff and if instead it chooses to let the mutual debts continue (perhaps collecting interest on the overdraft all the while), *D Bank*'s setoff power *after* the bankruptcy petition is accorded its full value. This has been termed the "bait" to convince banks not to set off in the midst of the debtor's financial crisis.[260] Of course, failure to manifest the setoff implies that in late March, *D Bank* has been honoring *D*'s checks against what would have been cash collateral in the bankruptcy. Since setoff is subject to the rule of "use it or lose it,"[261] *D Bank* has been enriching *D* by releasing value that *D Bank* could have retained. In essence, to the extent *D* has been writing checks against the credits and *D Bank* has not dishonored a check to defend its setoff, *D Bank* has been making unsecured loans to the debtor on the eve of bankruptcy which the Bankruptcy Code encourages[262] and which prudence discourages.

Significantly, if the March 10 debit is a setoff and not a payment,[263] *D Bank* is denied the "ordinary course" defense under section 547(c)(2). This is a defense that will protect banks most of the time.[264] Therefore, the view that overdraft eliminations are setoffs, not payments, is probably harmful to the banks.[265] We will soon reveal other disadvantages for *D Bank* if section 553(b) applies.[266]

---

258. Banks that are insiders of the debtor are subject to a one-year preference period. *Id.* § 547(b)(4)(B). Because section 553(b) refers to ninety days, insider banks may escape section 553(b) liability (where no insufficiency arises in the ninety-day period) but may be subject to voidable preference liability. Laws v. United Mo. Bank, N.A., 188 B.R. 263, 266 (W.D. Mo. 1995), *aff'd*, 98 F.3d 1047 (8th Cir. 1996), *cert. denied*, 520 U.S. 1168 (1997).

259. 11 U.S.C. § 552(b)(2) (2012).

260. Laurence & Janaway, *supra* note 130, at 108, 112, 118.

261. Schroeder & Carlson, *supra* note 118.

262. 11 U.S.C. § 547(c)(4) (2012) (unsecured loan after a voidable preference can be used to set off preference liability).

263. Laurence & Janaway, *supra* note 130, at 109.

264. If we ignore the banker's lien argument previously rehearsed. *See supra* text accompanying notes 202–05, 224–27.

265. Laurence & Janaway, *supra* note 130, at 109.

266. *See infra* text accompanying notes 358–59.

C. Provisional Debits

Suppose *D* has no funds in his account. Nevertheless, *D* writes a $90 check on *D Bank*. The check is presented to *D Bank* on March 4. *D Bank* is within its rights to dishonor the check.

Under Article 4's famous midnight deadline,[267] *D Bank* has until midnight on March 5 to ponder whether to honor or dishonor the check.[268] The check is not considered paid if *D Bank* dishonors the check before midnight of the banking day[269] following presentment of the check.[270] During this period of excogitation and sober reflection, *D Bank*, on March 4, will record the fact that the debtor's check has been presented, and that the two-day thinking period has started to run.[271] This record we may call a provisional debit.[272] Such a debit will be erased

267. U.C.C. § 4-104(a)(10) (2017) ("'Midnight deadline' with respect to a bank is midnight on its next banking day following the banking day on which it receives the relevant item or notice and from which the time for taking actions commences to run, whichever is later.").

268. Under U.C.C. section 4-301(b),

> If a demand item is received by a payor bank for credit on its books, it may return the item or send notice of dishonor and may revoke any credit given or recover the amount thereof withdrawn by its customer, if it acts within the time limit and in the manner specified in subsection (a).

Id. § 4-301(b). According to U.C.C. section 4-301(a),

> If a payor bank settles for a demand item . . . presented otherwise than for immediate payment over the counter before midnight of the banking day of receipt, the payor bank may revoke the settlement and recover the settlement if, before it has made final payment and before its midnight deadline, it
>
> (a) returns the item; or
>
> (b) sends written notice of dishonor or nonpayment if the item is unavailable for return.

Id. § 4-301(a). Notice that *D Bank* (as payor of *D*'s check) must provisionally settle for the presented item the day of receipt in order to obtain the extra day of rumination implied by the midnight deadline.

269. *Id.* § 4-104(a)(3) ("'Banking day' means the part of a day on which a bank is open to the public for carrying on substantially all of its banking functions.").

270. *Id.* § 4-301(a)(a) ("the payor bank may revoke the settlement and recover the payment settlement, if, before it has made final payment and before its midnight deadline, it . . . returns the item"). The midnight deadline is defined as "midnight on its next banking day following the banking day on which it receives the relevant item or notice or from which the time for taking action commences to run, whichever is later." *Id.* § 4-101(10). An item is paid when the bank has first done any of the following:

> (a) paid the item in cash;
>
> (b) settled for the item without having a right to revoke the settlement under the statute, clearing-house rule, or agreement; or
>
> (c) made a provisional settlement for the item and failed to revoke the settlement in the time and manner permitted by statute, clearing-house rule, or agreement.

Id. § 4-215(1).

271. Sarachek v. Luana Sav. Bank (*In re* Agriprocessors, Inc.), 490 B.R. 852, 857, 859–60 (Bankr. N.D. Iowa 2013).

272. They have also been called "an overdraft on paper. In reality, [the bank] has taken no action regarding the check at this point. [The bank] actually has until noon of the following business day to inform the clearing house whether it will honor or return the check." *In re* Chase & Sanborn Corp., 848 F.2d 1196, 1197 (11th Cir. 1988); *see* Jacobs v. State Bank (*In re* AppOnline.com, Inc.), 296 B.R. 602, 609 (Bankr. E.D.N.Y. 2003) ("It is inaccurate to characterize that negative balance as an 'over-

if, before midnight on March 5, the bank elects to dishonor the check.[273] Provisional debits barely appear in Article 4,[274] but they represent good record-keeping practice by banks.

Sometimes, when *D Bank* receives a check not properly payable, it will alert *D* that the check will be dishonored if a deposit is not received to cover the check. Suppose *D Bank* receives presentment of such a check on March 4, and notifies *D* that it needs funds by the end of March 5 or the check will be dishonored. Suppose, on the morning of March 5, *D* wires $100 to *D Bank*. *D Bank* therefore honors the check.

In *Sarachek v. Luana Savings Bank (In re Agriproccessors, Inc.)*,[275] the trustee argued that *D* owed *D Bank* on March 4. Therefore, the March 5 wire was a transfer on antecedent debt and hence preferential. This claim was properly rejected.[276] On March 4, *D Bank* was merely thinking of advancing funds to *D*. The loan was actually made the afternoon of March 5,[277] only after the morning wire had been received. If this were not correct, then everything received from the debtor on March 5 is a *prima facie* voidable preference.[278]

If it had succeeded, the trustee's argument would have disadvantaged depositary banks. In terms of the section 4-210(a) security interest that arises when *D Bank* advances against provisional credits, the security interest would be on antecedent debt. But the security interest is a statutory lien and so would not

draft.'"); *see also id.* at 616 ("that negative balance did not represent an overdraft, but reflected that the [deposit account] was in an NSF position").

273. *AppOnline.com*, 296 B.R. at 609 ("The Court finds that the [provisional] debit . . . as a result of presentment of . . . checks was not 'final payment' under UCC § 4-4-213, but, instead, a provisional settlement between [the bank] and its customer which could be revoked before the midnight deadline provided for under UCC § 4-301(1).").

274. *But see* U.C.C. § 4-402 cmt. 4 (2017) ("Banks commonly determine whether there are sufficient funds in an account to pay an item after the close of banking hours on the day of presentment when they post debit and credit items to the account."); *see also id.* § 4-104 cmt. 10 ("To a substantial extent the confusion, the litigation and even the resulting court decisions fail to take into account that in the collection process some debits or credits are provisional or tentative and others are final and that many debits or credits are provisional or tentative for awhile but later become final. Similarly, some cases fail to recognize that within a single bank, particularly a payor bank, each item goes through a series of processes and that in a payor bank most of these processes are preliminary to the basic act of payment or 'final payment.'").

275. 490 B.R. 852.

276. *AppOnline.com*, 296 B.R. 602; *but see* Zachary Gray Sanderson, Note, *An Argument for Creating an Exception to § 547 for Payments on Intraday Overdrafts*, 100 Iowa L. Rev. 1865, 1877 (2015) ("intraday overdrafts are antecedent debts under the terms of the Bankruptcy Code").

277. U.C.C. § 4-104(2) (2017) ("'Afternoon' means the period of a day between noon and midnight.").

278. According to the court in *AppOnline.com*,

> If the concept of provisional settlement as between the bank and its customer were eliminated, stop payment orders, garnishments and set-offs would all be ineffective if they arrived at the payor bank after forward settlement has been made with its presenting bank but before the payor bank has determined whether or not to honor the check, and the concept of the midnight deadline would, in effect, cease to exist.

296 B.R. at 618.

be a voidable preference.[279] A cash deposit or wire transfer following the provisional debit, however, would be an undefended voidable preference. This would undermine the practice of *D Bank* notifying *D* to fund the account in order to avoid dishonor.

D. Withdrawals Against Provisional Credits

Withdrawals against provisional credits are analytically very different from overdraft credits. Overdrafts are the extension of unsecured credit, but draws on provisional credits are secured transactions. To comprehend the difference, we must revise our hypothetical.

Suppose *D* has no balance in her checking account. On March 1, *D* issues a $90 check against no funds in its account.

Meanwhile, on March 5, *D* deposits *E*'s $100 check payable to the order of *D*. *D Bank* provisionally credits *D*'s account.[280]

On March 6, *D*'s $90 check is presented to *D Bank*. At this time, *D*'s checking account shows enough provisional credits to cover *D*'s check.

D Bank is well within its right to dishonor this check, as the provisional credit is not withdrawable as of right.[281] But we will assume that *D Bank* elects otherwise.[282] On March 7, *D Bank* honors *D*'s check. When this occurs, *D Bank* instantly becomes a secured creditor. It has a security interest in the item that *D* deposited on March 5.[283] *D Bank* at this point is the agent of *D* for the purpose of collecting the *E* check, but is an agent "coupled with an interest."[284] Whereas agents can be fired (i.e., have their authority canceled), an agent coupled with an interest cannot be similarly treated.

D Bank presents *E*'s check to *E Bank* on March 9. *E Bank* honors the item on March 10. *D Bank* receives the proceeds[285] and extinguishes the March 7 advance to *D* against provisional credits. The $10 surplus is unencumbered and withdrawable by *D* as of right.

D then files for bankruptcy on April 1.

279. 11 U.S.C. § 547(c)(6) (2012); *see supra* text accompanying notes 155–204.

280. This creates a $100 "ledger balance" in the parlance of some courts. Laws v. United Mo. Bank of Kansas City, N.A., 98 F.3d 1047, 1049 (8th Cir. 1996), *cert. denied*, 520 U.S. 1168 (1997). To be distinguished is the "collected funds balance" which

> does not give credit for uncleared deposits, but rather consists solely of the actually collected funds less debts to the account. Thus, if a customer is given provisional credit for deposits, checks written against the provisional credit would create a negative collected funds balance, but no overdraft on the ledger balance.

Feltman v. City Nat'l Bank (*In re* Sophisticated Commc'ns, Inc.), 369 B.R. 689, 696 (Bankr. S.D. Fla. 2007).

281. Pioneer Liquidating Corp. v. San Diego Trust & Sav. Bank (*In re* Consolidated Pioneer Mortg. Entities), 211 B.R. 704, 708 n.1 (S.D. Cal. 1997), *aff'd in part & rev'd in part on other grounds*, 166 F.3d 342 (9th Cir. 1999).

282. U.C.C. § 4-401(a) (2017) ("A bank may charge against the account of a customer an item that is properly payable from the account even though the charge creates an overdraft.").

283. *Id.* § 4-210(a).

284. Hunt v. Rousmanier's Adm'rs, 21 U.S. 174, 206 (1823).

285. *Consolidated Pioneer Mortg. Entities*, 211 B.R. at 711 n.7.

On these facts, *D Bank* has not received a voidable preference, even though *D* owed *D Bank* on March 5 and *D Bank*'s secured claim was extinguished on March 10. The *prima facie* case of the trustee fails.

The trustee can make out some (but not all) of the six elements of her cause of action. First, the debtor had a property interest in the item deposited. Second, the debtor transferred a security interest (by operation of law) to a creditor (*D Bank*).[286] Third, the transfer (presumptively) occurred when the debtor was insolvent. Fourth, the transfer was within ninety days of the bankruptcy petition.

Two elements, however, fail. We deal first with the issue of antecedent debt and then with the issue of the hypothetical liquidation test of section 547(b)(5).

1. Antecedent Debt

When *D* withdraws against provisional credits, *D* and *D Bank* are engaged in a contemporaneous exchange. *D Bank* gets a security interest on the item and *D* gets her check honored. There is no transfer on antecedent debt within the meaning of section 547(b)(2) and so, as to the attachment of *D Bank*'s section 4-210(a) security interest, the trustee's *prima facie* case against *D Bank* fails. Because the security interest is valid, collection of the items never gives rise to a voidable preference.

In our hypothetical, *D Bank* advanced funds on March 7. On this date, *D* was obligated to repay the advance. Ergo a debt exists from this point.[287]

Also on March 7, *D Bank* obtained a security interest on the item deposited on March 5. This security interest was contemporaneously exchanged for the March 7 advance and so the trustee may not recover the March 10 realization of the security interest.

Courts have disagreed with this simple analysis. In particular, courts have insisted that the March 7 advance is not a loan (and therefore not contemporaneously exchanged for a section 4-210(a) security interest).

In *Laws v. United Missouri Bank, N.A.*,[288] the district court thought that *D* owed *D Bank* on March 5, the day the provisional credits were issued.[289] In other words, a provisional credit supposedly signifies that *D* is conditionally obligated to repay *D Bank*. This is exactly backwards. On March 5, the provisional credit

286. A section 4-210(a) security interest happens to be a "statutory lien," which is a *defensive* consideration. *See supra* text accompanying notes 188–204. For the moment we focus on the *prima facie* case, and references to statutory liens are premature.

287. Walser v. Int'l Union Bank, 21 F.2d 294, 296 (2d Cir. 1927); Moseley v. Arth (*In re* Vendsouth, Inc.), No. 00-10112C-7G, 2003 Bankr. LEXIS 1437, at *7 (Bankr. M.D.N.C. Oct. 12, 2003); Howell v. Bank of Newnan (*In re* Summit Fin. Servs., Inc.), 240 B.R. 105, 114–15 (Bankr. N.D. Ga. 1999); Ries v. Firstar Bank Milwaukee, N.A. (*In re* Spring Grove Livestock Exch., Inc.), 205 B.R. 149, 155 (Bankr. D. Minn. 1997); A. Brooke Overby, *Allocation of Check Kiting Losses Under the UCC, Regulation CC, and the Bankruptcy Code: Reconciling the Standards*, 44 WAKE FOREST L. REV. 59, 103 (2009).

288. 188 B.R. 263 (W.D. Mo. 1995), *aff'd*, 98 F.3d 1047 (8th Cir. 1996). The district court is misinterpreted in *Spring Grove Livestock Exchange, Inc.*, 205 B.R. 149 at 155 ("The district court [in *Laws*] held that [*D Bank*'s] advances on [D's] uncollected deposits created antecedent debts . . . .").

289. 188 B.R. at 268 ("Because credit is extended [March 5] by the bank prior to final settlement [March 10], however, the bank has a claim against the depositor (and the depositor has a debt to the bank) in the amount of the provisional credit extended *regardless of whether the depositor makes use of this credit*." (emphasis added)).

signifies that *D Bank* conditionally owes *D*. The condition is that the deposited item is eventually collected, so that the provisional credit becomes withdrawable as of right. According to one court, "The extension of provisional credit [$90 on March 5] is similar to the issuance of a credit card. A credit card holder that has a $1,000 credit limit does not owe the issuer any money until the credit limit is reduced"[290]—i.e., the credit card is *used*.

A basic error in the district court's analysis is that "debt" (as in "antecedent debt") is the mirror image of "claim" as defined in the Bankruptcy Code.[291] "Claim" is defined as a "right to payment whether or not such right is . . . contingent"[292] On this view, a debtor's contingent obligation to pay is a debt for voidable preference purposes.[293] This view should be rejected. This assumption is admittedly supported by the definition of "debt" in Bankruptcy Code section 101(12)—"'debt' means liability on a claim." The exact wording of section 547(b)(2), however, is: "the trustee may avoid any transfer . . . (2) for or on account of an antecedent debt *owed by the debtor before such transfer was made*."[294] The emphasized language indicates that, when the debtor owes nothing because of a contingency, antecedent debt does not exist—even if the lender has committed to lend and has not yet been called upon to do so.[295]

The view of the district court has a disastrous side effect. To see this side effect, we amend our hypothetical. Suppose *D* deposits a $100 check drawn by *E* on March 5. According to the district court in *Laws*, *D* is now a debtor of *D Bank*. Suppose *D never* withdraws on the March 5 provisional credit. *D* is therefore the owner of the deposited item and *D Bank* is merely collection agent. As mere agent, *D Bank* presents the $100 check to *E Bank*. *E Bank* dishonors *E*'s check on March 6. Under U.C.C. section 4-214(a), *D Bank* may revoke the provisional credit.[296]

290. Howell v. Bank of Newnan (*In re* Summit Fin. Servs., Inc.), 240 B.R. 105 (Bankr. N.D. Ga. 1999); *see also* Richard Sauer, *Special Problems of Banks with Bankruptcy Debtor Customers*, 61 AM. BANKR. L.J. 95, 100 (1987) ("They are analogous to an open line of credit not drawn upon prior to bankruptcy.").

291. 188 B.R. at 267–68; *see* Sanderson, *supra* note 277, at 1878–80 (committing this error).

292. 11 U.S.C. § 101(54) (2012).

293. Daning v. Bozek (*In re* Bullion Reserve of N. Am.), 836 F.2d 1214, 1217 (9th Cir. 1988); Energy Coop., Inc. v. SOCAP Int'l, Ltd., 832 F.2d 947, 1001 (7th Cir. 1987).

294. 11 U.S.C. § 101(12) (2012) (emphasis added).

295. Mendelsohn v. Louis Frey Co. (*In re* Moran), 188 B.R. 492 (Bankr. E.D.N.Y. 1995) (commitment to lend more than ten days before perfection, but advance was after perfection; held no voidable preference); Whittaker v. Bancohio Nat'l Bank (*In re* Lamons), 121 B.R. 748, 751 (Bankr. S.D. Ohio 1990); *see also* Bernstein v. RJL Leasing (*In re* White River Corp.), 799 F.2d 631, 632 (10th Cir. 1986) ("a debt is incurred when a debtor first becomes legally bound to pay").

Section 60(a) had a provision that specifically dealt with a security interest that had attached by virtue of a commitment to lend, before the loan was actually made. According to section 60(a)(8):

> A transfer to secure a future loan, if such a loan is actually made, or a transfer which becomes security for a future loan, shall have the same effect as a transfer for or on account of a new and contemporaneous consideration.

Bankruptcy Act of 1898 § 60(a)(8). No such provision appears in section 547. On commitments to lend and voidable preference law, see Carlson, *Crucible*, *supra* note 30, at 242–44.

296. According to that section 4-214(a):

On the district court's reasoning, this revocation is a seizure of *D*'s property on antecedent debt. As such, revocation must be viewed as a transfer on antecedent debt. If the bank has no other collateral, revocation then becomes a voidable preference.[297]

Such a view is untenable. On March 5, *D* had nothing. On March 6, *D Bank* canceled nothing. No events took place. All we see is that *D Bank* undertook to collect a check and could not do so.

Because of this disastrous side effect, the view of the district court in *Laws* should be (and indeed on appeal was) rejected. Issuance of the provisional credit does not create a debt owed by *D*. The provisional credit is valueless and merely signifies that *D* has deposited items. Rather, a withdrawal *against* a provisional credit is the moment when *D* owes *D Bank*.

On appeal, the Eighth Circuit in *Laws* had a different theory of antecedent debt. Here we revert to our earlier working hypothetical.[298]

According to the Eighth Circuit, no debt existed on March 5 when a provisional credit was issued to *D*—a view contradicting that of the district court. No debt existed when *D* drew down $90 against the provisional credit on March 7. In fact, no debt *ever* existed. A debt *would have existed* if *E Bank* dishonored *D Bank*'s presentation of *E*'s check.[299] Dishonor translates the draws against provisional credits into pure overdrafts:

> If a collecting bank has made provisional settlement with its customer for an item and fails by reason of dishonor . . . to receive settlement for the item . . . , the bank may revoke the settlement given by it, charge back the amount of any credit given for the item to its customer's account, or obtain refund from its customer, whether or not it is able to return the item, if by its midnight deadline . . . it returns the item and sends notification of the facts.

U.C.C. § 4-214(a) (2017).

297. Ries v. Firstar Bank Milwaukee, N.A. (*In re* Spring Grove Livestock Exch., Inc.), 205 B.R. 149, 155 (Bankr. D. Minn. 1997) (ruling otherwise).

298. According to the hypothetical:

> March 1: *D* issues check.
>
> March 5: *D* deposits the *E* check.
>
> March 6: *D*'s check presented to *D Bank*.
>
> March 7: *D Bank* advances funds to *D*.
>
> March 9: *D Bank* presents *E*'s check to *E Bank*.
>
> March 10: *E Bank* honors *E*'s check.
>
> April 1: *D*'s bankruptcy petition.

299. This view garners feeble support from U.C.C. section 4-214, which provides:

> If a collecting bank has made provisional settlement . . . for an item and fails, by reason of dishonor . . . to receive settlement for the item . . . , the bank may . . . charge back the amount of any credit given for the item to its customer's account, or obtain a refund from its customer . . . .

U.C.C. § 4-214 (2017). The *Laws* view relies on the negative pregnant of this proposition: If upon dishonor, the collecting bank may get a refund, then, prior to dishonor, there is no right to a refund.

> But to say that advances drawn by the depositor are his property does not necessarily mean that the depositor thereby incurs a debt. The bank is the depositor's agent during the collection process. The bank routinely makes uncollected funds available to the depositor, not as a loan, but in recognition of the bank's anticipated debt to the depositor. Because the vast majority of deposits are collected, banks do not see the decision to make advances on uncollected deposits as a credit decision. It is a service decision, driven by laws such as the Expedited Funds Availability Act, and by the financial demands of bank customers.[300]

The view of the court of appeals is that *D* owned *E*'s check after it was deposited on March 5. Its ownership right was, however, subject to a springing executory interest. The condition subsequent in question was the honoring of the item on March 10. At that moment, the debtor's ownership interest terminated and the bank's ownership of the item sprang into a full ownership right. Between March 5 and March 10, the bank was merely the bailee of the item and agent of *D*. *D Bank* became the owner only on March 10. No debt was repaid. Only a condition subsequent was triggered.[301]

Such an interpretation, in effect, denies the implication of U.C.C. section 4-210, which provides that the bank had security interests in deposited checks. A security interest must "attach." Attachment requires that the creditor give "value."[302] Here the value given was the advance of funds—a *loan*. In short, the existence of the section 4-210(a) security interest proves that the debtor's withdrawal against provisional credits *is* the loan.[303] But it is a *fully secured loan*. This has an important though not decisive impact favoring the conclusion that no voidable preference occurred.[304]

The Eighth Circuit interpretation also implies that *D Bank* owns the $10 surplus and need not pay it to *D*. Recall that *D* drew down $90 on a provisional

---

300. Laws v. United Mo. Bank of Kansas City, N.A., 98 F.3d 1047, 1050–51 (8th Cir. 1996) (citation omitted), *cert. denied*, 520 U.S. 1168 (1997). In 1991, the comptroller of the currency took this position in a letter to a court in a different case. Pioneer Liquidating Corp. v. San Diego Trust & Sav. Bank (*In re* Consolidated Pioneer Mortg. Entities), 211 B.R. 704, 712 n.9 (S.D. Cal. 1997), *aff'd in part & rev'd in part on other grounds*, 166 F.3d 342 (9th Cir. 1999). The Ninth Circuit agreed with this proposition. *In re* Pioneer Liquidating Corp., No. 97-56238, 1999 U.S. App. LEXIS 517, at *3–4 (9th Cir. Jan. 12, 1999).

301. The district court in *Laws* had a similar view of the matter:

> It is perhaps accurate to say that, prior to final settlement the bank had a contingent right to ownership of the deposited items (the contingency being the clearance of the checks) and the depositor has ownership of the checks subject to a condition subsequent.

Laws v. United Mo. Bank, N.A., 188 B.R. 263, 267 (W.D. Mo. 1995), *aff'd*, 98 F.3d 1047 (8th Cir. 1996), *cert. denied*, 520 U.S. 1168 (1997).

302. U.C.C. § 9-203(2) (2017).

303. *See id.* § 4-211 ("For purposes of determining its status as a holder in due course, a bank has given value to the extent it has a security interest in an item . . . ."). The court also cited the fact that the comptroller of currency does not consider withdrawals against provisional credits to be debts in calculating whether a bank has exceed its lending limits. 98 F.3d at 1051. But this is only to say that lending against provisional credits is so unrisky that the regulators view it as no threat to bank liquidity. In fact, Article 4 *compels* the view that draws on provisional credits are loans because the security interest on deposited items, U.C.C. section 4-210(a), depends on this being true.

304. It is conclusive if *D Bank* collects, but not conclusive if the overdraft is paid by a cash deposit or wire transfer. *See infra* text accompanying notes 341–59.

credit for $100. If *D Bank* has a mere security interest on the $100 item, then *D* deserves the surplus.[305] But if on March 10, *D Bank* is the absolute owner of the item, *D Bank* may keep the surplus. Obviously such a view is untenable.

The court of appeals in *Laws* relied upon the absence of reported cases wherein a bank demanded repayment of the "loan" before an attempt to collect the items was made: "Because the bank collection process is rapid, there are no prior cases determining whether a bank has a legal right to recover advances on uncollected deposits *before those deposits are dishonored*. But it is worth noting that banks do not behave as though they have a right to repayment before dishonor."[306] But this is to confuse the necessary with the familiar. The existence of the security interest requires the view that the bank was a lender to its customer, with a security interest in the deposited items.

Under the facts of the case, the bank did not demand reimbursement for the amounts against the deposited checks. (According to the court, it had no *right* to reimbursement.) Rather, the bank threatened to deny future withdrawals against provisional credits unless the debtor agreed to pay interest on the negative balances. That the bank chose not to demand repayment does not exactly prove that it could not have done so. In any case, the debtor's promise to pay interest supposedly converted the non-loan into a loan. That meant summary judgment could not be awarded because, after a certain point, the withdrawals against provisional credit *were* loans because the bank demanded interest compensation.

But this does not follow.[307] One can lend money without interest compensation (in fact *Leviticus* commands it).[308] According to one commentator, this aspect of *Laws* is "puzzling for preference purposes; debt is debt whether routinely created or not."[309]

The *Laws* courts played havoc with the definition of antecedent debt perhaps out of fear that the bank otherwise would be liable, thereby threatening the very existence of the checking cashing system.[310] But they need not have worried. The bank usually wins, on our current hypothetical, for a different reason, where the bank reimburses itself from the proceeds of collected items deposited by the debtor. As we shall see, the trustee's *prima facie* case fails because of the hypothetical liquidation test, which we shall soon discuss.

A view similar to that found in the Eight Circuit's *Laws* opinion is proffered in *Pioneer Liquidating Corp. v. San Diego Trust & Savings Bank (In re Consolidated*

305. U.C.C. § 9-608(a)(4) (2017).

306. 98 F.3d at 1051.

307. Interest compensation for draws against provisional credits was held to be irrelevant in the following: *In re* Chase & Sanborn Corp., 848 F.2d 1196, 1201 (11th Cir. 1988); Jacobs v. State Bank (*In re* AppOnline.com, Inc.), 296 B.R. 602, 620 (Bankr. E.D.N.Y. 2003).

308. Leviticus 25:36 (King James version) ("Take thou no usury of him, or increase; but fear thy God; that thy brother may live with thee.").

309. Reilly, *supra* note 150, at 352.

310. For a case following the *Laws* definition of debt, see Feltman v. City Nat'l Bank (*In re* Sophisticated Commc'ns, Inc.), 369 B.R. 689, 697 (Bankr. S.D. Fla. 2007).

Pioneer Mortgage Entities).[311] In *Pioneer*, *D Bank* successfully and knowingly escaped a check kiting scheme.[312] The trustee[313] argued unsuccessfully that the escape[314] constituted a fraudulent conveyance (not a voidable preference),[315] in that the debtor's kiting of a check (to produce a provisional credit) was, supposedly, an attempt to hinder, defraud, and delay creditors. The court awarded summary judgment to *D Bank* on the remarkable theory that creation of a security interest under U.C.C. section 4-210(a) is not a "transfer" of debtor property.[316] This theory will be criticized later.[317]

For the moment our concern is whether an advance on a provisional credit is a "loan." The *Pioneer* court denied that advances against provisional credits are loans. The court complained that U.C.C. section 4-210(a)

> does not comport with reality. Although there is a sense in which a draw against provisional credit may be thought of as a loan, the customer's obligation to the bank is not a loan in the ordinary sense of the word . . . . [T]he satisfaction of the customer's obligation ordinarily requires no action by the customer. The customer never even knows when "repayment" occurs . . . .[318]

We pause to observe that a debt may in general exist and be extinguished without the debtor knowing it. Setoff is an obvious example. "Notification account receivable" financing is another. Suppose *D Bank* lends to *D* and a security agreement grants to *D Bank* all accounts. It is agreed that *D Bank* may notify the account debtors that they are to pay *D Bank* directly. Such a loan would liquidate itself without *D*'s knowledge. Therefore, the *Pioneer* court has given us no reason to deny that an advance on a provisional credit is a loan. In effect, liquidation of a section 4-210(a) security interest is directly analogous notification accounts receivable financing.[319]

We continue with the *Pioneer* court's observations about banking "reality":

> In the real world, a bank's advances to the customer seem more like a transfer of ownership in the deposited checks and less like a loan. The bank expects that it will be entitled to keep the proceeds of the check when it finally collects the funds from the payor bank. Likewise the customer recognizes that the bank is offering a service by allowing withdrawal before collection, and expects that the bank will keep the proceeds of the deposited checks.[320]

311. 211 B.R. 704 (S.D. Cal. 1997), *aff'd in part & rev'd in part on other grounds*, 166 F.3d 342 (9th Cir. 1999).

312. Kites will be discussed separately; *see supra* text accompanying notes 410–98. The classic description of a kite is set forth *infra* at note 418.

313. Or more precisely, the corporate assignee of bankruptcy avoidance actions.

314. More precisely, 473 transfers to *D Bank*, amounting to $71 million in total. *Consolidated Pioneer Mortg. Entities*, 211 B.R. at 709.

315. The trustee "abandoned the preference claim before trial in order to simplify the case for the jury." *Id.*

316. *Id.* at 714–15 (citations and footnotes omitted).

317. *See infra* text accompanying notes 499–506.

318. 211 B.R. at 712.

319. U.C.C. § 4-210 cmt. 3 (2017) ("in the normal case the bank's security interest is self-liquidating").

320. *Consolidated Pioneer Mortg. Entities*, 211 B.R. at 712–13.

Every word of this passage can be challenged. First, there is a transfer *to the customer*—the funds forwarded to *D*'s payee at *D*'s request. This transfer gives rise to a statutory lien, which is a contemporaneous transfer of the deposited item to the bank. If "ownership" means what is usually called "debtor equity" in collateral, then the transfer to *D Bank* is not a transfer of ownership but is the creation of a security interest. In addition, *D Bank* is not necessarily allowed to "keep the proceeds," as it would if it bought an "ownership" interest in the item. It may only reimburse itself for the *loan* that *D Bank* advanced to *D* on the provisional credit. Suppose *D* deposits a check for $100 and withdraws $90 on the provisional credit. *D Bank* may *not* keep all $100. *D Bank* may only keep $90, precisely because it claims a security interest to secure the *loan* that *D Bank* made in permitting *D* to withdraw the $90.

The *Pioneer* court continues:

> Although both parties understand that the customer somehow surrenders its interest in the check in exchange for the privilege of withdrawing funds, the U.C.C. expressly provides that the depositor remains the owner of the check while the check passes through the clearinghouse system. While this court will not judicially overwrite the U.C.C., harmonizing this ownership provision with banking reality and fraudulent transfer law is like forcing a square peg into a round hole. To reconcile these areas, an alternate, and what this court finds to be a better explanation of the operation of the bank's security interest, is that the division of interests in the deposited check is a division of legal and equitable interests. The customer's ownership interest is a legal interest in the check, and the Bank's security interest is an equitable interest in the proceeds of the check.
>
> The interest in property that [*D*] retained in the checks and that was later transferred to [*D Bank*] was equivalent to "bare legal title." When the Bank's equitable interest in proceeds (obtained by advancing funds to [*D*]) merged with legal title to the proceeds (which [*D*] transferred to [*D Bank*] as a matter of law upon completion of check collection), the Bank's security interest "liquidated," and the Bank became the outright owner of the proceeds. See U.C.C. § 4-210 comment (3). Because the interest that was transferred to the Bank when the Bank received the proceeds of the deposited check was not an equitable interest, [the bankruptcy trustee] cannot recover the value of the Bank's equitable interest in an avoidance action. Therefore, if [the bankruptcy trustee] is entitled to recover anything, its recovery would be limited to the value of bare legal title.[321]

These criticisms are unfair to Article 4, which unquestionably is a work of genius. Interpreting Article 4 is not fitting a square peg in a round hole. Indeed, it is the court's re-interpretation of banking reality that makes a square peg out of a round one.

Article 4 does indeed treat *D* as the "owner" of the item—in the sense of owning debtor equity in light of a security interest on the collateral. Article 4 does *not* assume that *D* "surrenders" its ownership interest when it draws on provisional credits. Rather, *D* transfers to *D Bank* a security interest on the deposited item. There is nothing incoherent about this.

321. *Id*. at 713 (most citations and one footnote omitted).

Furthermore, the court gets matters exactly backwards when it says that, rather than being a secured creditor, *D Bank* is the "equitable" owner of the item which *D* holds in trust for *D Bank*. In fact, *D Bank* is the agent and a fiduciary with regard to the item, but coupled with an interest in it. It is *D*—not *D Bank*—who has the equity. Indeed, "debtor equity" is the usual phrase that one hears when a creditor claims a lien on the debtor's property.[322] The phrase comes from the title theory of mortgages—language Article 9 eschews.[323] Generally, "debtor equity" means the difference between full ownership and a security interest on full ownership. The equity belongs to *D* and not to *D Bank*.

The *Pioneer* court gives no persuasive reason why advances on deposited items are not loans.

2. Hypothetical Liquidation Test

Recall that in our hypothetical, *D Bank* awards *D* a $100 provisional credit, *D* draws $90 against it, and *D Bank* reimburses itself from the proceeds of the item that *D* deposited before the draw.

On these facts, we have seen that there is a transfer but not a transfer on antecedent debt. Rather, we have a contemporaneous exchange of $90 advance in exchange for a security interest on a $100 item. So section 547(b)(2) ("for or on account of an antecedent debt owed by the debtor before such transfer was made") fails.

A second element of the trustee's *prima facie* case also fails. The trustee cannot prevail under section 547(b)(5), the hypothetical liquidation test. The failure is based on the fact that *D Bank* is obtaining cash proceeds of its security interest in deposited items.[324]

Realizing on cash collateral is *never* a voidable preference, provided the security interest on the original collateral was valid.[325] In fact, it is wrong to think, under the circumstances, that the bank was "paid." Rather, the bank has foreclosed on its collateral. Payment requires the will of debtor, but a foreclosure proceeds regardless of debtor consent.

To see why this is so, we conduct the hypothetical liquidation test. First, we imagine that *D Bank* returns the March 10 transfer ($90 received from *E Bank*) to a chapter 7 trustee. The return of the March 10 disposition hypothetically revives *D Bank*'s $90 claim for reimbursement. But as to this claim, *D Bank* is fully secured—by the very cash proceeds that were hypothetically surrendered. Now

322. The phrase is used in Bankruptcy Code section 362(d)(2)(A), which provides that the court shall lift bankruptcy's "automatic stay" in a chapter 7 case if "the debtor does not have an equity in such property." In fact, this should be read as *valuable* equity. If the debtor had literally *no* equity, the automatic stay would not apply in the first place. 11 U.S.C. § 362(d)(2)(A) (2012).

323. U.C.C. § 9-202 (2017) ("Except as otherwise provided with respect to consignments of sales . . . the provisions of this article with regard to rights and obligations apply whether title to collateral is in the secured party or the debtor.").

324. Feltman v. City Nat'l Bank (*In re* Sophisticated Commc'ns, Inc.), 369 B.R. 689, 698 (Bankr. S.D. Fla. 2007); Howell v. Bank of Newnan (*In re* Summit Fin. Servs., Inc.), 240 B.R. 105, 119 (Bankr. N.D. Ga. 1999).

325. *See supra* text accompanying notes 56–57.

we imagine *D Bank*'s bankruptcy dividend in the hypothetical chapter 7 case. *D Bank* is entitled to its cash collateral under Bankruptcy Code section 725[326] before the unsecured creditors receive anything under section 726(a). Thus, what *D Bank* surrenders is exactly equivalent to what *D Bank* receives in the hypothetical chapter 7 case. *D Bank* has not been preferred, and the trustee's *prima facie* case fails.[327]

With regard to overdraft cases, we suggested that perhaps *D Bank* is not "paid" but rather manifests a setoff. Is that possibility valid in the case of an advance against a provisional credit?

The answer is no. Recall that *D Bank* has collected an item and has applied it to extinguish an advance given on a provisional credit. The advance resulted in a security interest on the items that gave rise to the provisional credit. According to section 4-210(c):

> Receipt by a collecting bank of a final settlement for an item is a realization on its security interest in the item . . . and proceeds . . . .[328]

This provision precludes the possibility that *D Bank* has manifested a setoff. Rather, *D Bank* is foreclosing on cash collateral. Mere receipt of cash proceeds by *D Bank* signifies the extinction of *D Bank*'s claim against *D* and so setoff is

---

326. According to this provision:

> After commencement of a case under this chapter, but before final distribution of property of the estate under section 726 of this title, the trustee, after notice and a hearing, shall dispose of any property in which an entity other than the estate has an interest, such as a lien, and that has not been disposed of under another section of this title.

11 U.S.C. § 725 (2012).

327. Garner v. Knoll, Inc. (*In re* Tusa-Expo Holdings, Inc.), 811 F.3d 786, 792 (5th Cir. 2016) ("if a creditor receives a transfer which, by its very nature, would not have been available to any of the other secured or unsecured creditors, it could never receive 'more' under the hypothetical Chapter 7 individual analysis" (footnote omitted)). We have spent some time with Laws v. United Mo. Bank, N.A., 188 B.R. 263 (W.D. Mo. 1995), *aff'd*, 98 F.3d 1047 (8th Cir. 1996), *cert. denied*, 520 U.S. 1168 (1997). The case involved a wire transfer against full security. It should also be noted that, after the wire occurred, further advances on provisional credits were made. (The district court refers to these as the "November transactions." 188 B.R. at 267 n.1.) These resulted in collections from security interests on items to compensate for a draw against provisional credits. As such, they were not "payments" but rather foreclosures on contemporaneously exchanged security interests on items. The district court, however, excused the bank on the ground that it was a "mere conduit." *Id.* at 272. That is, the bank had been presented with checks against provisional credit. The payees of these checks were recipients of voidable preferences. The bank was therefore not a transferee at all. This makes no sense. The bank clearly did receive security interests on the items deposited. It was in effect an entity that refinanced unsecured debt with secured debt. The reference to conduits is irrelevant and unnecessary. On conduits, see *supra* text accompanying notes 168–77.

328. U.C.C. § 4-210(c) (2017). Oddly, Article 9 never quite says that when a secured party obtains possession of cash proceeds, the secured obligation is satisfied. The closest Article 9 comes to such a statement is:

> If so agreed, and in any event after default, a secured party:
>
> . . . .
>
> (2) may take any proceeds to which the secured party is entitled . . . .

This sentence does not quite preclude the possibility that the secured party may grab cash, hold it "for the debtor," and allow interest to accrue on the as-yet-unsatisfied secured claim. Nor does Article 9 ever quite say that the secured party has power to apply the cash proceeds to extinguish the secured claim. Common sense must supply what Article 9 leaves unsaid.

not the appropriate concept.[329] Once the secured party "takes" the cash proceeds,[330] *D Bank*'s claim is automatically extinguished.

3. The Implications of *Barnhill*

Foreclosing on a security interest is never a voidable preference (where the underlying security interest is valid). Few would disagree! Yet the conclusion contradicts the Supreme Court's reasoning in *Barnhill v. Johnson*.[331] The fact that *Barnhill* cancels out a key premise of Article 4 of the U.C.C. is yet another reason why that holding needs to be re-thought.

Recall that the creditor Barnhill received a check on antecedent debt before the preference period. The check was honored within the preference period. The Supreme Court ruled that Barnhill received a voidable preference. But to reach that conclusion, it must have been the case that the ultimate payment was not proceeds of the check Barnhill deposited. According to the Supreme Court, "receipt of a check gives the recipient no right in the funds held by the bank on the drawer's account."[332] This says that when Barnhill did receive payment, there was a disconnect between the check presented and the payment received. In other words, the check did not *cause* the payment. The payment does not "proceed" from the check. In relevant part, Article 9 defines "proceeds: as

(A) whatever is acquired upon . . . exchange, or other disposition of collateral;

(B) whatever is collected on, or distributed on account of, collateral;

(C) rights arising out of collateral.[333]

The Supreme Court denies that the payment was *in exchange* for the check, or that payment was collected *on account* of the check, or that payment *arises out* of the check

It has been held that *Barnhill* is relevant in cases involving bank customers who have deposited items with its depositary bank.[334] If that is true, then, in our hy-

329. *See supra* text accompanying notes 126–51. *Laws*, 188 B.R. at 266, involved October wire transfers to pay a draw on provisional credits and November collections against deposited items. The October wire (if deemed followed by a setoff) was not subject to section 553(b) scrutiny because October was not within the ninety-day preference period. 188 B.R. at 267, The November collections were within ninety days of bankruptcy. But they escaped section 553(b) scrutiny because collection of items are never setoffs but are Article 9 foreclosures. The *Laws* court never mentioned section 553(b), which is fair enough. It decided that *D Bank* was never a transferee of the collections, because *D Bank* was "mere conduit" of funds. The *real* initial transferees of the collected funds were payees on the checks *D* wrote on the provisional credits. This is true but the court mixes apples and oranges. Yes, the payees received *D* property out of *D*'s deposit account, but *D Bank* was a transferee of collections from items on which *D Bank* had a security interest. "Mere conduit" (discussed *supra* in the text accompanying notes 168–77) was completely unnecessary to the analysis.

330. *See* U.C.C. § 9-607 (2017) ("after default, a secured party may take any proceeds").

331. 503 U.S. 393 (1992), *discussed in supra* text accompanying notes 107–21.

332. *Id.* at 399.

333. U.C.C. § 9-102(a)(64) (2017).

334. Laws v. United Mo. Bank of Kansas City, N.A., 98 F.3d 1047, 1050 (8th Cir. 1996) *cert. denied*, 520 U.S. 1168 (1997); Sarachek v. Luana Sav. Bank (*In re* Agriprocessors, Inc.), 490 B.R. 852, 861 (Bankr. N.D. Iowa 2013).

pothetical, *D Bank*, on March 10, was not receiving proceeds of its security interest in the *E* check. Rather, it was receiving *D*'s unencumbered property for the first time when *E Bank* honored *E*'s check. *Barnhill* turns on a disjunction between the check issued and *E Bank*'s payment of it. If this principle is applied generally, *Barnhill* contradicts section 4-210(a), which creates a security interest in deposited items for depositary banks that advance loans on provisional credits.

Barnhill purports to be a federal reading of the defined term "transfer."[335] The definition in effect at that time[336] invoked the word "property," a word *undefined* in the Bankruptcy Code.[337] Chief Justice Rehnquist, citing that old warhorse *Butner v. United States*,[338] purported to follow state law, not realizing that his misdescription pulverized the soul of Article 4. It seems quite justifiable to view *Barnhill* as a sort of "*Erie* guess."[339] As such, it is a bad guess and is best ignored.

One must choose between the logic of the Supreme Court and the logic of Article 4 of the U.C.C. I assume that the U.C.C. prevails over the Supreme Court—on *Butner* grounds. On U.C.C. logic, *D Bank*'s collections from *E Bank* are proceeds of the check *E* transmitted to *D*.

4. Non-Check Deposits

When *D Bank* reimburses itself from proceeds of deposited items, it has not received a voidable preference because it was not "paid" (with unencumbered dollars). Rather, it foreclosed on its security interest.

The matter is more complicated when *D* reimburses *D Bank* by other means. In *Laws v. United Missouri Bank of Kansas City, N.A.*,[340] for, example, a check-kiting customer had drawn down prodigiously from provisional credits resulting from kited checks. To reduce the amount it owed *D Bank*, *D* wired funds to *D Bank*. Happily for *D Bank*, all the kited checks eventually cleared. *D Bank* was at all times a fully secured creditor. *D Bank* could have waited to realize cash proceeds of kited items, but it accepted a wire transfer of unencumbered

335. 503 U.S. at 397–98 ("'What constitutes a transfer and when it is complete' is a matter of federal law." (quoting McKenzie v. Irving Trust Co., 323 U.S. 365, 369–70 (1945))).

336. The definition of "transfer" was rewritten in 2005. At the time of *Barnhill*, the Bankruptcy Code defined "transfer" to be "every mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with *property* or with *an interest in property*, including retention of title as a security interest and foreclosure of the debtor's equity of redemption." 11 U.S.C. § 101(54) (Supp. II 1998) (emphasis added). This definition dates to 1986. 503 U.S. at 397 n.4.

337. For the anti-*Butner* view that federal law has its own definition of "property," see David Gray Carlson, *The Federal Law of Property: The Case of Inheritance Disclaimers and Tenancy by the Entireties*, 75 Wash. & Lee L. Rev. 3 (2018).

338. 440 U.S. 48, 54 (1979) ("Congress has generally left the determination of property rights in the assets of a bankrupt's estate to state law.").

339. Haley N. Schaffer & David F. Herr, *The Eighth Circuit: Why Guess?* Erie *Guesses and the Eighth Circuit*, 36 Wm. Mitchell L. Rev. 1625, 1625 (2010) ("An '*Erie* guess' is an attempt to predict what a state's highest court would decide if it were to address the issue itself.").

340. 98 F.3d 1047 (8th Cir. 1996).

funds. *D* filed for bankruptcy shortly after the wire transfer.[341] The bankruptcy trustee claimed that the wire was a voidable preference.

Properly, this is not a section 4-210(a) case—a case where *D Bank* realized on collateral. Nevertheless one observes a fully secured creditor receiving payment. Since fully secured creditors have no duty to be equal to the unsecured creditors, it would seem at first thought that the bank was not preferred—that the trustee could not make out a case under the hypothetical liquidation test in section 547(b)(5).

In fact, the hypothetical liquidation test is more complicated than that. Basically, the test imagines that, on the day of the bankruptcy petition, the bank returns *unencumbered dollars* to the hypothetical bankruptcy estate. In our prior analysis, *D Bank* hypothetically returned *encumbered* dollars and (hypothetically) took them right back again. *D* Bank claimed a section 4-210(a) security interest in the *E* check. But now *unencumbered* dollars are returned, because *D Bank* had no security interest in the wire transfer. That is a rather different assumption.

Once the unencumbered dollars are returned, *D Bank*'s claim revives,[342] and *D Bank* is entitled to any collateral that happens to be on hand in the hypothetical bankruptcy estate. But, whatever collateral existed when *D Bank* received the wire transfer, that collateral may have disappeared by the time of the bankruptcy. Once *D Bank* was reimbursed, *D*'s provisional credits became final settlements withdrawable as of right. Deposit accounts have a way of dissipating just prior to a bankruptcy petition.[343]

Valuation of the hypothetical chapter 7 estate, therefore, takes place when the bankruptcy petition is actually filed. This was the holding in *Palmer Clay Products Co. v. Brown*,[344] where Justice Louis Brandeis wrote:

> Whether a creditor has received a preference is to be determined, not by what the situation would have been if the debtor's assets had been liquidated and distributed among his creditors at the time the alleged preferential payment was made, but by the actual effect of the payments as determined when bankruptcy results. The payment on account of say 10% within the four months will necessarily result in such creditor receiving a greater percentage than other creditors, if the distribution in bankruptcy is less than 100%. For where the creditor's claim is $10,000, the payment on

341. The debtor wired funds to the bank on October 19, 1986, and the bankruptcy petition occurred on February 13, 1987. Laws v. United Mo. Bank, N.A., 188 B.R. 263, 265 (W.D. Mo. 1995), *aff'd*, 98 F.3d 1047 (8th Cir. 1996), *cert. denied*, 520 U.S. 1168 (1997). Although the wire occurred more than ninety days before the bankruptcy petition, the bank was ruled an insider of the debtor, so that the one-year preference period of section 547(b)(4)(B) applied to the case. *Id.*

342. 11 U.S.C. § 502(h) (2012) ("[a] claim arising from the recovery of property under section . . . 550 . . . shall be determined, and shall be allowed . . . or disallowed . . . the same as if such claim had arisen before the date of the filing of the petition").

343. If indeed *D* withdrew those funds, perhaps he bought some "things" with them that are in the bankruptcy estate. These "things" are second-generation proceeds of cash proceeds and so *D Bank* can claim those things. Even so, the security interest on these things is unperfected in twenty-one days. U.C.C. § 9-315(d) (2017). This view depends upon no financing statement to perfect a security interest in the items. If *D* met a payroll or bought services, there are no proceeds and *D Bank* cannot claim that its bankruptcy dividend is 100 percent equal to its reimbursement by wire transfer.

344. 297 U.S. 227 (1936).

> account $1000, and the distribution in bankruptcy 50%, the creditor to whom the payment on account is made receives $5500, while another creditor to whom the same amount was owing and no payment on account was made will receive only $5000. A payment which enables the creditor "to obtain a greater percentage of his debt than any other of such creditors of the same class" is a preference.
>
> We may not assume that Congress intended to disregard the actual result, and to introduce the impractical rule of requiring the determination, as of the date of each payment, of the hypothetical question: What would have been the financial result if the assets had then been liquidated and the proceeds distributed among the then creditors?[345]

In this influential passage, Justice Brandeis makes the point that an unsecured creditor always benefits from being paid when the debtor is insolvent, because the creditor gets the payment plus the later bankruptcy dividend.[346] In the course of making this point, Justice Brandeis also established that valuation of the estate itself must occur on the day of the bankruptcy petition.[347]

This timing point extends to valuing collateral. The reason for the valuation is that the collateral itself, as it exists in the hypothetical chapter 7 proceeding, is part of the secured party's hypothetical dividend.[348] Therefore, it follows that this distribution must be considered as it existed on the day of bankruptcy.

The effect of this rule is that, at least as a preliminary matter, the secured party suffers the consequences of depreciation of collateral between the time of the challenged transfer and the time of the bankruptcy petition. For example, suppose *D Bank* was oversecured at the time it was paid by wire. Because of subsequent withdrawals as of right, *D Bank* is undersecured at the time of the bankruptcy petition. *D Bank* flunks the hypothetical liquidation test, and the wire is potentially *prima facie* voidable.[349]

There is good defensive news for *D Bank*. So far, when the deposit account falls to zero by the time of the bankruptcy petition, the trustee can establish the *prima facie* case for voidable preference. That is, receipt of the wire transfer confers more benefit than receipt of the hypothetical liquidation dividend contemplated by section 547(b)(5). Happily for *D Bank*, however, receipt of the wire transfer is defended by section 547(c)(1). The payment of unencumbered dollars

345. *Id.* at 229.

346. The unsecured creditor may be compared to the beggar who says, "You know, if I were as rich as Rockefeller, I'd be richer than Rockefeller, because I'd continue to do a little begging on the side."

347. *Accord* Taunt v. Fidelity Bank (*In re* Royal Golf Prods. Corp.), 908 F.2d 91, 95 (6th Cir. 1990); Countryman, *supra* note 72, at 741; 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. Rev. 1, 44 (1983).

348. 11 U.S.C. § 725 (2012).

349. Official Unsecured Creditors Comm. v. U.S. Nat'l Bank (*In re* Suffola, Inc.), 2 F.3d 977, 985 (9th Cir. 1993); Gray v. A.I. Credit Corp. (*In re* Paris Indus. Corp.), 130 B.R. 1, 3–4 (Bankr. D. Me. 1991); *but see* Schwinn Plan Comm. v. Transamerica Ins. Fin. Co. (*In re* Schwinn Bicycle Co.), 182 B.R. 514 (Bankr. N.D. Ill. 1995) (valuation at the time of payment, not the time of bankruptcy). For a check kiting case that overlooks the holding of *Palmer Clay Products*, see Pereira v. Summit Bank, 94 Civ. 1565 (WHP), 2001 U.S. Dist. LEXIS 1712 (S.D.N.Y. Feb. 21 2001), discussed *infra* in the text accompanying notes 385-87.

resulted in a release of collateral—the proceeds of the encumbered items which *D* later withdrew. Release of a valid security interest is considered new value under section 547(a)(2).[350] Thus, *D Bank* received unencumbered dollars, but it released its security interest in the proceeds of the deposited items. The deposited items resulted in final credits withdrawable as of right. These newly liberated dollars the debtor has, by assumption, spent freely. Thus, although the payment itself is a transfer on antecedent debt, the secured party simultaneously gave back new value by the *pro tanto* release of the security interest. The secured party—oversecured at the time of payment and undersecured at the time of bankruptcy—will be eligible for the defense in section 547(c)(1).[351] This analysis mitigates the harm done by asserting a bankruptcy day valuation under section 547(b)(5).

Thus, in *MacLeod v. First National Bank (In re Sosebee Freight, Inc.)*,[352] *D Bank* in fact claimed that it had advanced on provisional credits and that the advances were not overdrafts. If this were true, *D Bank* would be a secured creditor, and payment would not be a voidable preference. The court dismissed this claim because *D Bank* presented no evidence that it was true.[353] According to Bankruptcy Code section 547(g):

> the trustee has the burden of proving the avoidability of a transfer under subsection (b) of tis section, and the creditor . . . has the burden of proving the nonavoidability of a transfer under subsection (c) of this section.[354]

At first glance, it would appear that the court misassigned the burden of proof. But if the facts were that the deposit account had nothing in it on the day of bankruptcy, then in fact *D Bank was* asserting the section 547(c)(1) defense, which required *D Bank* to bear the burden of proof that collateral was released to the debtor by virtue of the payment.

The analysis just proffered may be compared to a theory set forth in *Feltman v. City National Bank (In re Sophisticated Communications, Inc.)*[355]:

> Assume on Day 1, the customer has no funds in the account and no uncleared checks. He deposits $200,000 in checks and the bank honors checks totaling $300,000. At the end of Day 1, there is a negative collected funds balance of minus $300,000 and a ledger balance overdraft of $100,000 since the customer received provisional credit for the $200,000 deposit. On Day 2, the customer wires $300,000 from an outside source into his account. Under this Court's analysis, $200,000 of the $300,000 transfer would not be avoidable as a preference since that amount of the negative collected funds balance arose from provisional credit on deposited items and *was not an antecedent debt*. By contrast, $100,000 of the

350. 11 U.S.C. § 547(a)(2) (2012) (new value includes "release by a transferee of property previously transferred to such transferee in a transaction that is neither void nor voidable by the debtor or the trustee under any applicable law, including proceeds of such property").

351. Ward & Shulman, *supra* note 348, at 76–77.

352. Case No. 01-42006, 2004 Bankr. LEXIS 2201 (Bankr. N.D. Ga. 2004).

353. *Id.* at *5.

354. 11 U.S.C. § 547(g) (2012).

355. 369 B.R. 689, 699 (Bankr. S.D. Fla. 2007).

> $300,000 could be the subject of a preference claim. First, the $100,000 ledger balance overdraft on Day 1 is an extension of credit and therefore an antecedent debt. Second, the bank's security interest in the deposited items only secured the $200,000 provisional credit granted in respect of those items, not the $100,000 in additional credit granted by the bank.[356]

This interpretation follows the questionable Eighth Circuit *Laws* view that a draw on a provisional credit is not a debt. As a result, the bank in the court's hypothetical avoids the *Palmer Clay Products* rule. Properly, the wire transfer to the undersecured bank is a *prima facie* voidable preference. But the bank is entitled to a section 547(c)(1) defense for $200,000 because that part of the wire released the bank's $200,000 security interest on deposited items. Thus, the court answers its hypothetical correctly but for the wrong reason.

The above analysis of *Laws* presupposes that, by wiring funds, *D* "paid" its secured obligation on the draw against provisional credits. This is possible if the wire was accompanied by an instruction or, in the absence of an instruction, if *D Bank* intended the deposit to pay the overdraft. But where the wire was just a deposit of unencumbered funds with no instructions, and where *D Bank* did not eliminate the overdraft immediately, the wire transfer in *Laws* was really a setoff, not a payment. Application of section 547(b) would then constitute a jurisdictional error. Rather, section 553(b) applies.

Application of section 553(b) to the facts in *Laws* reveals a significant flaw in the Bankruptcy Code—it has no principle resembling section 547(c)(1). As we have seen, section 553(b) is a two-point test comparing "insufficiencies" in the deposit account itself. Thus, at the time the bank in *Laws* permitted a withdrawal on provisional credits, an insufficiency arose, even though the insufficiency was fully collateralized by security interests in uncollected deposited checks. That insufficiency decreased when the bank received the wire transfer. As a result, the bank's setoff is recoverable to the extent of the wire.[357] Meanwhile, section 547(c)(1), which would have saved the bank if it had been "paid," is not on the scene. The avoidance of the setoff revives the bank's claim, but if the collateral has been dissipated, the bank loses out under section 553(b).

In *Laws*, *D Bank* was fortunate that the wire occurred more than ninety days before bankruptcy, and that no insufficiency arose during the ninety-day period of section 553(b). As a result, the bank escaped section 553(b) scrutiny. But it was made subject to voidable preference scrutiny since *D Bank* (allegedly aware of the check kiting) was considered an insider of *D*, thereby triggering the one-year look-back in section 547(b)(4)(B). But this presupposes that *D* or (in the absence of *D*'s intent) *D Bank* intended the wire to retire its interest-bearing obligation to *D Bank*. If this was true, voidable preference law applies and setoff

356. *Id.* at 699 (emphasis added) (footnote and citation omitted).

357. In *Howell v. Bank of Newnan*, the court considered other collateral in determining whether an insufficiency existed for the purposes of section 553(b). Strictly speaking this was not permitted, though it conforms to the spirit of voidable preference analysis. *In re* Summit Fin. Servs., Inc., 240 B.R. 105, 121–22 (Bankr. N.D. Ga. 1999).

law did not. But if *D Bank* was reimbursed by setoff, voidable preference law was irrelevant.

A final consideration. Receipt of a wire transfer of unencumbered cash by *D Bank* when *D Bank* has advanced against provisional credits may generate the section 547(c)(1) "contemporaneous exchange" defense. But this invites the bankruptcy court to *value* the collateral. In a check kiting case, this poses a serious challenge for *D Bank*. If the deposited "kite" items are valued in a perfect market (where everyone knows about the kite), they are valueless, and the (c)(1) defense is defeated. If the items are valued in the *actual* market (where no one knows about the kite), the collateral obtains a value nearly consistent with the face value of the items. A choice of valuation standard will determine the liability of *D Bank* if *D Bank* is paid by wire transfer. This conundrum exists even if, in historical life, *D Bank* was left holding the tail of the kite. If the deposited items were dishonored, they *still* might have value at the time of the wire if the market expected the items to be collected.

Choice of valuation standards, however, is *not* appropriate if *D Bank* obtains proceeds of deposited items. In such a case, valuation is unnecessary. It suffices to observe that, whatever the odds of collection, the items were in fact collected and constituted a foreclosure of the security interest—not payment by unencumbered funds. Thus, payment by wire transfer is analytically different from collection of encumbered items.

5. Failure of Collateral

When *D Bank* advances a loan[358] on provisional credits, *D Bank* is a secured creditor with a lien on the deposited items.[359] If *D Bank* collects from the proceeds of items on which the provisional credit is founded, *D Bank* is innocent of voidable preference, because foreclosing a valid lien is never culpable. What happens when *D Bank* fails to collect the item and *D* pays the overdraft later by wire or other deposit?

Fitting this question into a revised version of our hypothetical, suppose on March 4, *D* deposits a $100 item drawn by *E* and receives a provisional credit. On March 5, *D Bank* permits a withdrawal of $90 on the provisional credit, thinking that the deposited item will clear, as items usually do. As a result, *D Bank* has a section 4-210(a) security interest on the $100 item. Suppose on March 9, *E* issues a "stop payment"[360] order to *E Bank*. Following this instruction, *E Bank* dishonors the item on March 10.[361] On March 11, *D Bank* demands reimbursement of the

358. *But see* Laws v. United Mo. Bank of Kansas City, N.A., 98 F.3d 1047, 1051 (8th Cir. 1996) (denying such advances are loans unless *D Bank* charges interest), *cert. denied*, 520 U.S. 1168 (1997).

359. U.C.C. § 4-210(a) (2017).

360. *Id.* § 4-403(a).

361. This occurred in *White Family Cos. v. Slone (In re Dayton Title Agency, Inc.)*, 724 F.3d 675 (6th Cir. 2013), where *D Bank* charged back the provisional credit ($4.885 million) and set off $740,000 from the account, even though these funds were known to be held in trust for clients of *D*. The case would appear to be an injustice for this and many other reasons. *See* Jeanne L. Schroeder & David Gray Carlson, *Loan Proceeds and Article 9 Proceeds*, 49 U.C.C. L.J. (forthcoming 2018).

withdrawal. *D* pays *D Bank* by wiring $90 into *D*'s account. Since *D Bank*'s secured claim on the $100 item has been satisfied, *D Bank* this returns this item to *D*, as the law requires.[362] On April 1, *D* is bankrupt.

It is possible that the wire transfer is a *prima facie* voidable preference. The $90 payment[363] is a transfer on antecedent debt. The trustee can invoke the hypothetical liquidation test. If *D Bank* returns the suspected preference of $90 (in unencumbered dollars) and enters the hypothetical liquidation, *D Bank*'s secured claim against the returned item is revived. If the item has a value of $90 or more, the trustee loses the *prima facie* case. If that item is valued at less than $90, then *D Bank* flunks the test. *D Bank*'s hypothetical bankruptcy dividend would then be the value of the item plus a pro rata dividend on its unsecured deficit. Since this dividend is sure to be worth less than the $90 payment received in real time, *D Bank* has been preferred.

Assuming the trustee can show a *prima facie* case, the $90 wire also redeemed the $100 item on which *D Bank* had a security interest. The wire transfer to *D Bank*, in fact, has a dual nature. First, *D* has made a payment on antecedent debt. But *D*'s payment resulted in the release of *D Bank*'s security interest in the dishonored item. The March 11 return of the item constitutes "new value" under section 547(a)(2): payment of the secured claim constitutes

> release by a transferee of property previously transferred to such transferee in a transaction that is neither void not voidable by the debtor or trustee under any applicable law.[364]

Thus, there is a contemporaneous exchange of wire transfer for return of the collateral to *D*. In effect, the wire transfer is proceeds of the dishonored item. It follows that the trustee may not avoid the *entire* March 11 wire as a voidable preference. *D Bank* is entitled to a partial (c)(1) defense depending on the value of the dishonored $100 item.[365]

362. Spillman Inv. Grp., Ltd. v. Am. Bank (*In re* Spillman Dev. Grp., Ltd.), 401 B.R. 240, 256 (Bankr. W.D. Tex. 2009). Article 9 nowhere says this. Instead, we have the following comment:

> Although Section 9-207 addresses directly the duties of a secured party in possession of collateral, that section does not require the secured party to relinquish possession when the secured party ceases to hold a security interest. Under common law, absent agreement to the contrary, the failure to relinquish possession of collateral upon satisfaction of the secured obligation would constitute a conversion. Inasmuch as problems apparently have not surfaced in the absence of statutory duties under former Article 9 and the common-law duty appears to have been sufficient, this Article does not impose a statutory duty to relinquish possession.

U.C.C. § 9-209 cmt. 4 (2017). Although the drafters declined to legislate on this issue, they also acknowledge a common law duty to release the collateral when the security interest goes out of existence through payment.

363. I assume for the moment that the wire is a payment and not a deposit that it later set off.

364. 11 U.S.C. § 547(a)(2) (2012).

365. In *Henderson v. Cmty., Bank*, *D* deposited checks with *D Bank* and made withdrawals against the provisional credits. *D Bank* presented the checks to *E Bank*, which allegedly dishonored them. *D Bank*, however, claimed that *E Bank* had missed its midnight deadline. Before this dispute was settled, *D* wired funds (from *E Bank*) to *D Bank*. The wire was a voidable preference if *E Bank* met its midnight deadline. It was no voidable preference if *E Bank* failed to dishonor in a timely manner. In such a case, the wire was proceeds of encumbered items. Since the status of timely dishonor was a

The hypothetical we are discussing is simply a depositary bank version of a classic voidable preference case, *Abramson v. St. Regis Paper Co. (In re Abramson)*,[366] decided under the 1898 act. To quote myself, in *Abramson*,

> the debtor sold equipment worth $186,000 to an unsecured creditor for $66,500. The difference—$119,500—just happened to be the outstanding claim of the creditor. The sale was a contemporaneous exchange, but it was also a transfer that extinguished an antecedent debt. The court ordered the creditor to return the difference between the value of the equipment purchased and the price the creditor paid. If this case had been decided under the Bankruptcy Code, one would say that the entire transfer—worth $186,000—was voidable, but that § 547(c)(1) provides a partial defense "to the extent" new value was given contemporaneously.[367]

In our hypothetical, how should the $100 item be valued? As of March 10, we note that, because of the dishonor, *E* was obligated to pay the check according to its terms.[368] Furthermore, *D Bank* was a holder in due course of this check, if *D Bank* had no knowledge of *E*'s counterclaim or defense.[369] This dishonored item therefore had some value—perhaps *face* value if *E* was solvent.

Complicating the matter is the fact that if *D* were to bring an action against *E* for drawer's liability,[370] *E* could make a counterclaim (if she has one) for whatever caused *E* to stop payment on the check. For example, suppose *E* wrote the $100 check for a blender. The blender, however, violated the implied warranty of merchantability.[371] *E* therefore has a counterclaim (or, more accurately, a recoupment) for the entire $100 (assuming the blender has zero value as scrap). *D Bank* was a holder in due course who took free of this defense.[372] *D Bank* transferred its rights as a holder in due course to *D*.[373] But, in *D*'s bankruptcy, *E* can file a proof of claim for breach of warranty. This raises the specter that *E* improves from an unsecured creditor of *D* to a secured creditor by virtue of its right of setoff.[374] But this is not the case. If *D*'s bankruptcy trustee sells the $100 item, that person becomes a holder in due course because *D* was, and *E*'s recoup-

factual dispute, the court declined to award summary judgment to either side. *In re* Stinson Petroleum Co., No. 09-51663, 2011 Bankr. LEXIS 1421 (Bankr. S.D. Miss. Apr. 21, 2011).

366. 715 F.2d 934 (5th Cir. 1983).

367. Carlson, *Crucible*, *supra* note 30, at 248.

368. U.C.C. § 3-414(b) (2017).

369. *Id.* §§ 3-302(a)(2), 4-211.

370. *Id.* § 3-414(b).

371. *Id.* § 2-314.

372. *Id.* § 3-305(a)(3), (b).

373. According to U.C.C. section 3-203(b):

> Transfer of an instrument, whether or not the transfer is a negotiation, vests in the transferee any right of the transferor to enforce the instrument, including any right as a holder in due course, but the transferee cannot acquire the rights of a holder in due course by a transfer, directly or indirectly, from a holder in due course if the transferee engaged in fraud or illegality affecting the instrument.

Id. § 3-203(b). Although breach of warranty is an "illegality," it is not an "illegality affecting the instrument." Therefore, *D* inherits *D Bank*'s status as a holder in due course.

374. 11 U.S.C. § 506(a) (2012).

ment disappears.[375] That is, *E* is unsecured in *D*'s bankruptcy but *E* owes \$100 to a future holder in due course. *E* has no setoff right in *D*'s bankruptcy. The dishonored item, therefore, has value even in *D*'s hands, because the item can be sold for some positive amount.

This theory was acknowledged, after a fashion, in *General Motors Acceptance Corp. v. Union Bank & Trust Co.*[376] The case is not one involving voidable preferences. Rather it was a priority contest between two competing secured parties. The case turned on the issue of whether a deposit following dishonor of an encumbered item constituted proceeds of that item.

In *Union Bank*, *D* was a car dealer who received "floor plan financing" for *new* cars from *SP*.[377] *D Bank* provided floor plan financing for *used* cars.[378] *D* sold twelve used cars to E_1 who wrote 12 checks. *D* deposited these checks, received provisional credits, and withdrew funds on said credits. E_1 stopped payment on the checks and *E Bank* dishonored them.

D was therefore in a serious overdraft position with *D Bank*. *D* then sold *new* cars and received new checks from E_2. These checks were proceeds of new cars. As such, the E_2 items were proceeds encumbered by *SP*'s security interest. *D* deposited these checks with *D Bank*. *D Bank* collected these checks and reimbursed itself for *D*'s draw against provisional credits.

SP sued *D Bank* for conversion. *D Bank* noted that its section 4-210(a) security interest on the dishonored items was a superpriority security interest,[379] and it claimed that the newly deposited items (encumbered by *SP*'s proceeds security interest) were superpriority proceeds of the dishonored items. Specifically, the claim was that the superpriority connected with the section 4-210(a) used car items transferred to the new car items. Reversing the lower court, the *Union Bank* court found this premise to be false, given the facts of the case:

> We are persuaded a better interpretation of § 4-210(c) limits the "proceeds" of an item (here a check) . . . to funds collected or exchanged for the same item. Proceeds include funds paid out by a presenting bank to the payee or funds directly received in exchange for the item. Thus, when a depositary bank advances funds on checks that are never converted to proceeds because payment is stopped, the checks are dishonored and returned to the depositary bank with no proceeds having been created to which a security interest can attach.[380]

375. U.C.C. § 3-305(a)(3) (2017) ("The right of a holder in due course to enforce the obligation of a party to pay the instrument is . . . not subject to . . . claims of recoupment stated in subsection (a)(3) against a person other than the holder.").

376. 329 F.3d 594 (8th Cir. 2003).

377. That is, *SP* claimed a security interest in both inventory and accounts of *D*.

378. Or to be precise, *D Bank* was the *senior* secured party as to used cars thanks to a subordination agreement that *SP* had executed. 329 F.3d at 596.

379. U.C.C. § 4-210(c)(3) (2017) ("the security interest has priority over conflicting perfected security interests in the item . . . or proceeds").

380. 329 F.3d at 599.

Because the new car items were not themselves proceeds of the dishonored items, *D Bank*'s superpriority on the dishonored used car items did not carry over to the newly deposited new car items.

The *Union Bank* court, however, makes clear that the new car items *could* have been proceeds of the dishonored used car items—*if D Bank* had expressly traded the dishonored items back to *D* for the new deposit:

> [N]or did [*D Bank*] tender the dishonored checks to [*D*] in exchange for money or other value. On July 23, [*D Bank*] returned the 12 dishonored checks to [*D*] and received nothing from [*D*] in exchange for the dishonored items. Based on a plain reading of [§ 4-210(c), *D Bank*'s] security interest in the 12 dishonored checks terminated when it relinquished possession of the items.[381]

In short, *D Bank* blundered. Had it properly traded the dishonored items back to *D* in exchange for the new deposit, the new deposit would have been proceeds of its section 4-210(a) security interest in used car items and *D Bank* would have had priority over *SP*.

The *Union Bank* court, however, overlooked the fact that, once *D* paid the overdraft, *D Bank* had a pledgor's duty to return the dishonored items to *D*. Payment by *D* automatically releases the section 4-210(a) security interest, and this should have provided the link between the superpriority collateral and the new car items, such that the superpriority pertaining to the dishonored used car items transfers into the new car proceeds.

Dishonored items may have value in an ordinary case. A different conclusion is required in check kiting cases, where the dishonored items released to *D* are *D*'s own checks on *E Bank* ordering *E Bank* to pay *D*. Obviously such checks warrant a very low valuation indeed.

In *Laws v. United Missouri Bank of Kansas City, N.A.*,[382] the court properly ruled that "deposited checks in an ongoing check kite are not worthless."[383] But this is so only if collection succeeds. In such a case, *D Bank* has successfully realized on its security interest. But where the kited check is dishonored, *D Bank*'s collateral is probably worthless. When *D Bank* releases the dishonored items back to *D* in exchange for payment of the overdraft, a valuation must occur, but a valuation at or near zero can be expected.

D Bank probably got away with voidable preference murder in *Pereira v. Summit Bank*,[384] where *D Bank* found itself holding the tail of the kite while lucky

381. *Id.* at 598. The deposit of new car items had occurred on July 10.

382. 98 F.3d 1047 (8th Cir. 1996).

383. *Id.* at 1052; *see also* First Tenn. Bank, N.A. v. Stevenson (*In re* Cannon), 237 F.3d 716, 720–21 (6th Cir. 2001); Howell v. Bank of Newnan (*In re* Summit Fin. Servs., Inc.), 240 B.R. 105, 119 (Bankr. N.D. Ga. 1999) ("A deposit is not worthless if it is honored by the drawee bank."); Emerson v. Fed. Sav. Bank (*In re* Brown), 209 B.R. 874, 887 (Bankr. W.D. Tenn. 1997).

384. 94 Civ. 1565 (WHP), 2001 U.S. Dist. LEXIS 1712 (S.D.N.Y. Feb. 21, 2001).

E Bank escaped the kite. As a result, *D* had a sizable overdraft. To cover the overdraft, *D* deposited various checks. *E Bank* also wired funds to *D Bank*. The wire seems to have been stemmed from *E Bank*'s decision to honor some of the previously dishonored checks after all.[385] If this is correct, this wire would not be a voidable preference because the wire represents proceeds of items on which *D Bank* had a section 4-210(a) security interest. The other deposits paid the overdraft and were therefore *prima facie* voidable preferences. Properly, *D Bank* should have been liable for all these other deposits minus the market value of the dishonored kite checks—which is presumptively near zero.

The court held otherwise, however:

> Nevertheless, whether [*D Bank*] had the right as a secured creditor to liquidate its interest in the kited checks upon accepting $15,500,000 in wire transfers and deposits from [*D*'s] customers requires a more detailed analysis. In this case, [*D*] did not satisfy [*D Bank*'s] security interest by directly depositing funds into the account or indirectly causing funds from other sources to be deposited into the account. Funds came into the [*D*] account through the normal business operations of [*D*'s] customers. However, courts do not focus on the source of the funds used to liquidate the security interest, but on whether the bank would have been a secured creditor in bankruptcy. Under UCC Article 4, [*D Bank*] obviously would be secured. Therefore, even if [*D Bank*] rejected or returned the wire transfers and deposits from [*D*'s] customers, [*D*] would have neither acquired a benefit nor suffered a loss. Its customers would have had smaller claims against the debtor's estate, while [*D Bank*] would have had a correspondingly larger claim. Still, [*D*'s] total assets and liabilities would remain unchanged.[386]

The *Pereira* opinion is confusing and concerns itself unduly with who knew what and when about the kite—facts irrelevant to voidable preference analysis. The point is that *D* Bank was paid after the kite crashed. The dishonored kite items were treated as valuable collateral. Although the court treats the deposits as proceeds of dishonored items, it failed to do the valuation that *Abramson* requires. The deposits were both a payment on antecedent debt and also payments that released a security interest. But the dishonored items were checks written by *D* requiring *E Bank* to pay *D*. Such dishonored items have little or no value. They should not have generated any appreciable section 547(c)(1) defense.

Although the exchange of dishonored items for subsequent deposits should be enough to assure that the subsequent deposit is "proceeds," an "on us" check interferes

385. *See id.* at *20–21 ("At approximately 6:00 p.m. that evening, [*E Bank*] wired to [*D Bank*] the sum of $1,570,000 comprising the balance in the [*D*] account at [*E Bank*]."); *id.* at *42 ("Accordingly, [*D Bank*] had the right to liquidate its security interest in the kited checks upon the collection of the $1,570,000 payment from [*E Bank*]."), *id.* at *43 ("The value of [*D Bank*'s] security interest was reduced by the $1,570,000 sum received from [*E Bank*] as a reconciliation of payment obligations on May 27.").

386. *Id.* at *42–43.

with this conclusion. In *Moseley v. Arth (In re Vendsouth, Inc.)*,[387] *D Bank* maintained a checking account for *D* at one branch. At another branch, *D Bank* maintained a lockbox account for the benefit of *SP*, a lender with a perfected security interest in *D*'s inventory. *D* was to deposit checks received from customers in the lockbox account. These items were proceeds of inventory.[388] *SP* had control over the lockbox account (although the case occurred before the 2000 amendments had introduced "control" as a method of perfection).[389]

Deceptively, *D* wrote checks on its checking account at branch A and deposited the items in the lockbox account at branch B. The idea was to mislead *SP* into thinking that the level of its collateral was higher than it really was. These deceptive deposits were not proceeds of *D*'s inventory. Not realizing the checks were "on us," *D Bank* recorded provisional credits in the lock box on these items, against which *SP* was permitted to draw.

To reduce this case to our prior example, *D* deposited a $100[390] "on us" check in the lockbox. *D* then requested *SP* to wire $100 to *D*'s checking account to cover the "on us" check.[391] *SP* agreed to do this, and to finance the wire, *SP* swept the $100 from the lockbox account. One banking day lapsed between the sweep of the lockbox and the wire into the checking account.

If *D Bank* had a security interest on the "on us" check, then *D Bank* received no voidable preference. It advanced $100 on Day One, instantly obtained a security interest on the deposited "on us" item, and realized on proceeds of the item on Day Two. The case turned on whether the "on us" check was collateral for *D Bank*.

The court determined that the "on us" check was not collateral and that *D Bank* was unsecured when it received *SP*'s wire. According to U.C.C. section 4-210(a):

> A *collecting bank* has a security interest in an item . . .
>
> (1) in case of an item deposited in an account, to the extent to which credit given for the item has been withdrawn or applied . . . .[392]

387. No. 00-10112C-7G, 2003 Bankr. LEXIS 1437 (Bankr. M.D.N.C. Oct. 9, 2003).

388. U.C.C. § 9-(a)(9) (2017) (cash proceeds includes proceeds that are checks).

389. Under the 2000 amendments, control by a nonbank third party requires that "(2) the debtor, secured party, and bank have agreed in an authenticated record that the bank will comply with instructions originated by the secured party directing disposition of the funds in the deposit account without further consent by the debtor; or (3) the secured party becomes the bank's customer with respect to the deposit account." *Id.* § 9-104. "Control" does not imply, however, that the secured party necessarily has a security interest in the deposit account itself, as opposed to the proceeds deposited in the account. The debtor must *agree* to this. *Id.* § 9-203(b)(3)(B). Or, alternatively, the secured party is the direct customer of the bank, in which case debtor consent is irrelevant.

390. In the case, deposits of this sort aggregated to $106 million. *Vendsouth*, 2003 Bankr. LEXIS 1437, at *54.

391. The actual wire was $1,977,000. *Id.* at *8.

392. U.C.C. § 4-210(a) (2017) (emphasis added).

Certainly the "on us" check was an item. "Item" is defined as "an instrument or a promised or order to pay money handled by a bank for collection or payment."[393] An "instrument" is a "negotiable instrument." An "on us" check would appear to be a negotiable instrument.[394] So far *D Bank* would seem to be protected, though we must swallow the fact that *D*, as principal, can order *D Bank* as agent to pay *D Bank* as payee. We have already conceded this point when we accepted the fact that, contrary to Supreme Court precedent,[395] an "on us" check is always a "payment" and never a "setoff."

Where *D Bank* foundered was that *D Bank* was not a "collecting bank" under section 4-210(a). A "collecting bank" is "a bank handling an item for collection *except the payor bank*."[396] Since *D Bank* was the payor bank it could not be a collecting bank and so had no security interest under section 4-210(a). Because it had no security interest, *D Bank* received unencumbered funds on antecedent debt within the preference period.

In *Vendsouth*, *D Bank* argued that, in North Carolina, every branch is a separate bank. Therefore, Branch A was the collecting bank and Branch B was the payor bank. Since Branch A was a collecting bank, *D Bank* had a section 4-210(a) security interest. Although this argument would have worked in California,[397] it failed in the Tarheel State. Different branches are different banks for *some* purposes.[398] For instance, when calculating the midnight deadline, every branch is a separate bank. But generally, *D Bank* was only one bank in North Carolina.[399] It could not be both the collecting bank and the payor bank.

393. *Id.* § 4-104(a)(9).

394. *Id.* § 3-104(a). This section defines "negotiable instrument" as

> an unconditional promise or order to pay a fixed amount of money . . . if it
>
> (1) is payable to bearer or to order at the time it is issued or first comes into possession of a holder;
>
> (2) is payable on demand or at a definite time; and
>
> (3) does not state any other undertaking . . . by the person . . . ordering payment . . . .

395. Studley v. Boylston Nat'l Bank, 229 U.S. 523, 529 (1913), discussed *supra* in the text accompanying notes 142–45.

396. U.C.C. § 4-106(5) (2017). *Cf. id.* § 4-105 cmt. 3 ("A bank that takes an 'on us' item for collection, for application to a customer's loan or first handles the item for other reasons is a depositary bank even though it is also a payor bank.").

397. *See* Pioneer Liquidating Corp. v. San Diego Trust & Sav. Bank (*In re* Consolidated Pioneer Mortg. Entities), 211 B.R. 704, 708, 715–16 (S.D. Cal. 1997), *aff'd in part & rev'd in part on other grounds*, 166 F.3d 342 (9th Cir. 1999).

398. *E.g.*, U.C.C. § 4-102(b) (2017) (branches count for choice of law purposes).

399. According to section 4-106, comment 4:

> Assuming that it is not desirable to make each branch a separate bank for all purposes, this section provides that a branch or separate office is a separate bank for certain purposes. In so doing the single legal entity of the bank as a whole is preserved, thereby carrying with it the liability of the institution as a whole on such obligations as it may be under. On the other hand, in cases in which the Article provides a number of time limits for different types of actions by banks, if a branch functions as a separate bank, it should have the time limits available to a separate bank.

Id. § 4-106 cmt. 4.

Although a security interest under section 4-210(a) was ruled out, perhaps a *contract* between *D Bank* and *D* could grant a security interest in "all items"—a clause broad enough to take in the "on us" check. Or perhaps the old common law "banker's lien" on commercial paper in the bank's possession[400] would suffice.[401] In such a case, *D Bank* could have escaped voidable preference liability.

In *Vendsouth*, however, the court found there was no banker's lien: "The security interest asserted by [*D Bank*] does not involve a lien upon tangible property and hence finds no support in the common law."[402] It is hard to accept this, however; the "on us" check was very tangible indeed. The entire idea of negotiable instrument law is to "reify" rights into a piece of paper.[403]

The idea that *D Bank* could take a security interest in an item issued by *D* ordering *D Bank* to pay itself may seem to be a bootstrap-style contradiction. But this is not so. Under the 2000 amendments to Article 9, *D Bank* may take a security interest in the account it maintains on behalf of *D*.[404] Under Article 4 (and contrary to *Barnhill v. Johnson*)[405] a check is a conditional interest in the payment it induces.[406] Therefore, *D Bank*'s security interest on the "on us" check is a corollary to the axiom that *D Bank* may take a security interest in the deposit account itself.

As it stood, in *Vendsouth*, *D Bank* made an unsecured advance and received a wire a little later. Could the bank in *Vendsouth* claim the section 547(c)(1) defense? This would require that the wire be intended by *D* and *D Bank* to be "a contemporaneous exchange for new value given to the debtor."[407] Notice that the new value need not be supplied by the preferred creditor to the debtor. New value supplied by *SP* would suffice so long as *D* and *D Bank* intended for that new value be supplied. *SP*, however, may have been an oversecured creditor. If so the wire was a secured advance. New value is defined in section 547(a)(2) as "money's worth in . . . new credit." This should be interpreted to mean new *unsecured* credit.[408] Therefore, if *SP* was oversecured at the time it wired funds to *D Bank*, the section 547(c)(1) defense was not available.

400. Annotation, *Lien of Bank Upon Commercial Paper Delivered to It by the Debtor for Collection*, 22 A.L.R.2d 478 (1948).

401. The continuing existence of such a lien is acknowledged in U.C.C. section 4-210, comment 1.

402. Moseley v. Arth (*In re* Vendsouth, Inc.), No. 00-10112C-7G, 2003 Bankr. LEXIS 1437, at *34 (Bankr. M.D.N.C. Oct. 12, 2003).

403. James Steven Rogers, *Negotiability as a System of Title Recognition*, 48 Ohio St. L.J. 197, 200 (1987).

404. Schroeder & Carlson, *supra* note 118.

405. 503 U.S. 393 (1992).

406. *See supra* text accompanying notes 332–40.

407. It is clear that *D Bank* did not intend to advance unsecured credit. *D Bank* had supplied *D* with computer access so that *D* "was able to determine, not later than 10:00 a.m. each day, the checks that would hit the [checking account] that day, [*D*] could then communicate with [*SP*] and arrange for [*SP*] to wire transfer sufficient funds into the [checking account] so that all of the checks that would be presented that day would clear." *Id.* at *4.

408. As explained in Carlson & Widen, *supra* note 67, at 625–27.

In earmarking terms, if *SP* was undersecured at the time of the wire, then we observe one unsecured creditor (*SP*) replacing another unsecured creditor (the bank). If however, *SP* is an oversecured creditor, earmarking becomes inappropriate: a *secured* creditor replaces an unsecured creditor, and the bankruptcy estate is diminished. Earmarking is not permitted under such circumstances.

6. Fatting the Region's Kites

Many of the cases discussed herein involve check kiting.[409] In this section of the article, I maintain that, properly, successful exit from classic check kiting scheme is never a voidable preference.[410]

Under Article 4, a bank need not honor a check against merely provisional credits.[411] But federal legislation pressures banks to do so. Under the Expedited Funds Availability Act ("EFAA"),[412] a bank must make the provisional credit withdrawable as of right within two days, if the presented check is local.[413] Out-of-town checks must be made withdrawable as of right within five days.[414] But thanks to a Federal Reserve Bank regulation, almost *all* checks are considered local these days.[415] Therefore, although EFAA addresses bank abuses in not making funds available, it also encourages banks to make themselves vulnerable to kites.[416]

409. Laws v. United Mo. Bank of Kansas City, N.A., 98 F.3d 1047, 1051 (8th Cir. 1996), *cert. denied*, 520 U.S. 1168 (1997); First Tenn. Bank, N.A. v. Stevenson (*In re* Cannon), 237 F.3d 716, 720 (6th Cir. 2001); Pioneer Liquidating Corp. v. San Diego Trust & Sav. Bank (*In re* Consolidated Pioneer Mortg. Entities, Inc.), 211 B.R. 704, 708 n.1 (S.D. Cal. 1997), *aff'd in part & rev'd in part*, 166 F.3d 342 (9th Cir. 1999); Henderson v. Cmty. Bank (*In re* Stinson Petroleum Co.), No. 09-51663-NPO, 2011 Bankr. LEXIS 1421 (Bankr. S.D. Miss. 2011); Moseley v. Arth (*In re* Vendsouth, Inc.), No. 00-10112C-7G, 2003 Bankr. LEXIS 1437, at *7 (Bankr. M.D.N.C. Oct. 12, 2003); Howell v. Bank of Newnan (*In re* Summit Fin. Servs., Inc.), 240 B.R. 105, 119 (Bankr. N.D. Ga. 1999); Emerson v. Fed. Sav. Bank (*In re* Brown), 209 B.R. 874 (Bankr. W.D. Tenn. 1997); Ries v. Firstar Bank Milwaukee, N.A. (*In re* Spring Grove Livestock Exch., Inc.), 205 B.R. 149, 157 (Bankr. D. Minn. 1997); *In re* Montgomery, 123 B.R. 801 (Bankr. M.D. Tenn. 1991), *aff'd*, 136 B.R. 727 (M.D. Tenn. 1992), *aff'd*, 983 F.2d 1389 (6th Cir. 1993); Bernstein v. Alpha Assocs. (*In re* Frigitemp), 34 B.R. 1000, 1015 (S.D.N.Y. 1983), *aff'd*, 753 F.2d 230 (2d Cir. 1985).

410. In some cases, payees of kited checks, not the depositary bank, are the defendants. *E.g.*, McCuskey v. Nat'l Bank (*In re* Bohlen Enters., Ltd.), 859 F.2d 561 (8th Cir. 1988). Such cases are beyond the scope of this article. For analysis, see Carlson & Widen, *supra* note 67, at 630–33.

411. "If depositary banks only allowed their customers to have access to . . . funds from deposited checks after the bank had received a final payment or settlement for the checks, it would be impossible for kiting to occur." Overby, *supra* note 288, at 63–64 (footnotes omitted).

412. 12 U.S.C. §§ 4001–4010 (2012).

413. 12 C.F.R. § 229.12(b) (2017).

414. *Id.* § 229.12(c).

415. The Federal Reserve Bank has declared that all banks are deemed located in the Federal Reserve district of Cleveland for the purposes of check clearing. 12 C.F.R. Part 229.13 sets forth a number of exceptions to this rule.

416. *See* Overby, *supra* note 288, at 79 ("vaguely tolerant of kiting").

Let us examine the simplest of kites.[417] *D* has two banks, *D Bank* and *E Bank*.[418] There are no funds on deposit with either bank. *D* writes a check for $100 on *E Bank* and deposits it with *D Bank*. *D Bank* rewards *D* with a provisional credit. *D* writes a $100 check on *D Bank* and deposits it with *E Bank*. *E Bank* rewards *D* with a provisional credit. *D* then withdraws $90 from *D Bank* on the provisional credits registered at *D Bank*. At this point, *D Bank* has a security interest in the deposited item—the kited check written on *E Bank*.[419]

Thereafter, *D Bank* presents the deposited check to *E Bank*. *E Bank* pays because *E Bank* has granted a provisional credit to *D* based on a deposit with *E Bank* of a check written on *D Bank*. *D* thus has $90; *D Bank* has collected $100 and has applied $90 to retire its advance to *D*. *E Bank* hopes to collect $100 from *D Bank*. *D* can keep the kite going by carefully depositing a new

417. The classic description comes from *Williams v. United States*, 458 U.S. 279 (1982), and is a quote from the solicitor general's brief:

> The check kiter opens an account at Bank A with a nominal deposit. He then writes a check on that account for a large sum, such as $50,000. The check kiter then opens an account at Bank B and deposits the $50,000 check from Bank A in that account. At the time of deposit, the check is not supported by sufficient funds in the account at Bank A. However, Bank B, unaware of this fact, gives the check kiter immediate credit on his account at Bank B. During the several-day period that the check on Bank A is being processed for collection from the bank, the check kiter writes a $50,000 check on his account at Bank B and deposits it into his account at Bank A. At the time of the deposit of that check, Bank A gives the check kiter immediate credit on his account there, and on the basis of that credit pays the original $50,000 check when it is presented for collection.
>
> By repeating this scheme, or some variation of it, the check kiter can use the $50,000 originally given by Bank B as an interest-free loan for an extended period of time. In effect, the check kiter can take advantage of the several-day period required for the transmittal, processing, and payment of checks from accounts in different banks.

Id. at 281 n.1.

418. Sophisticated schemes may involve many banks. *See, e.g.*, Town & Country State Bank v. First State Bank, 358 N.W.2d 387 (Minn. 1984) (five banks).

419. U.C.C. § 4-210(a) (2017). In a nonkiting case, *D*'s deposit will typically consist of *E*'s check made payable to *D*. Here, *D* deposits *D*'s own check on *E Bank* with *D Bank*. One of the requirements for a security interest is that *D* must have rights in the collateral. U.C.C. § 9-203(a)(1) (2017). Can we say that *D* has rights in a check of which *D* is drawer? The answer is yes. First, simplistically but adequately, *D* owns the piece of paper that *D* deposits. This is just as true when *E* is the payor or *D* is the payor. In contradiction with *Barnhill*, discussed *supra* text accompanying notes 332-40, section 4-210(c) assumes that the final settlement that *D Bank* gets from *E Bank* is proceeds of this piece of paper.

In *In re Montgomery*, 983 F.2d 1389 (6th Cir. 1993), *D Bank* claimed the kited check was not *D*'s property but rather was the property of *E Bank*. The district court thought that the fact *D* "controlled" the deposit proved the check and the proceeds behind it were *D*'s property. The court sensibly responded:

> There cannot be a voidable preference, obviously, without a transfer of an interest in "property." We think it clear that such an interest was transferred here. The property consisted of cash equivalents deposited by [*D*]. There is no conceptual reason why credits in a bank account may not constitute property of the estate, and the fact that much of the property at issue here was created illegally does not mean that it was not "property." [*D*] unquestionably owed [*D Bank*] more than $2 million at a point in time within the preference period, and this debt was unquestionably paid in full prior to the filing of the bankruptcy petitions. The payment of the debt was not an optical illusion; the debt was paid by transfers of property interests.

Id. at 1392–93.

check with *D Bank* drawn on *E Bank*. But in our simple example, we suppose that *D Bank* lawfully dishonors the check because it finds that *D* has only $10 of credits withdrawable as of right and no provisional credits. Shortly thereafter, *D* files for bankruptcy.

Check kiting is a sophisticated form of bank robbery.[420] Banks invest in sophisticated expertise and software to detect kites,[421] but wicked customers nevertheless continue to kite checks successfully. One of the banks in the kite will bear the loss ("holding the tail of the kite"). The others may well escape with no loss.

Under the U.C.C., there is no scheme for pooling losses caused by kites. In our above example, *E Bank* was left holding the tail of the kite. *D Bank* escaped unscathed through successful collection.[422] "[I]n kites the usual rule is to take yours and may the devil take the hindmost."[423]

The Federal Reserve Bank has regulations, but they do not force the sharing of losses among banks. They require prompt reporting if kiting activity is spotted[424] and prompt return of dishonored items.[425] They add a duty of ordinary care[426] that is of possible but minor importance in kiting cases.[427] These regulations, however, fall short of requiring the exiting bank to surrender payments on kited checks.

In *McLemore v. Third National Bank (In re Montgomery)*,[428] the court suggested that constructive trust theory might undo successful exit from a kite.[429] Under this theory, *D* effectively robs *E Bank* and gives the proceeds to *D Bank*. Theft routinely gives rise to a constructive trust in favor of the victim.[430] Thus, the pro-

420. *See* 18 U.S.C. § 1344 (2012); United States v. Burnett, 989 F.2d 100, 102 (2d Cir. 1993) (kiting a "type of criminal activity").

421. *See* Frost Nat'l Bank v. Midwest Autohaus, 241 F.3d 862, 865–66 (7th Cir. 2001) (describing the "Vector 9 Heck Kite Suspect Computer System").

422. Pereira v. United Jersey Bank, N.A., 201 B.R. 644, 666 (S.D.N.Y. 1996) (describing how *D Bank* shifted the loss to *E Bank* by early detection).

423. James J. White & Robert S. Summers, Uniform Commercial Code 523 (5th ed. 2000); *see also* Overby, *supra* note 288, at 100 ("the UCC ruthlessly rewards the bank that manages to extricate itself from a kite first and, moreover, is neutral on the practice of kiting through its refusal to allocate the losses in most cases after final payment" (footnote omitted)).

424. A bank that suspects criminal activity is required to file a "suspicious activity report" with regulators. 12 C.F.R. §§ 208.62, 353 (2017).

425. *Id.* § 229.30.

426. *Id.* § 229.38(a).

427. Overby, *supra* note 288, at 82.

428. 983 F.2d 1389 (6th Cir. 1993).

429. In *Davis v. Security National Bank*, 447 F.2d 1094, 1099 (9th Cir. 1971), *D Bank* accepted deposits after the crash of a kite. *D Bank* tried to evade liability by claiming the deposits were trust property belonging to customers of *D*, but *D Bank* was not permitted to plead this. Instead, the court treated the deposit as consisting of unencumbered funds following a true overdraft. Such a holding smacks of *jus tertii*, the principle that a defendant in a property case may not plead that property need not be turned over because some third party owns the property. David Fox, *Relativity of Title at Law and in Equity*, 65 Cambridge L.J. 330, 332 (2006).

430. *See* Restatement of Restitution § 160 (1937).

ceeds of the check written on *E Bank* is the *res* of a trust in which *E Bank* has a beneficial interest.[431]

The trouble with constructive trust theory is that *D Bank* is a purchaser[432] for value of the proceeds of the item deposited. In a kite, *D Bank* has paid value (by allowing withdrawal on provisional credits). If *D Bank* has no knowledge of the kite, *D Bank* is a bona fide purchaser for value who takes the proceeds free and clear (for $90) of *E Bank*'s constructive trust claim.

In our example, *E Bank* can only claim the $10 surplus as constructive trust property, and even this requires that the $10 be traceable into the bankruptcy estate. For this reason, constructive trust theory is disappointing to *E Bank*. It is also a theory to which the bankruptcy trustee has no access.[433]

In terms of pooling losses, courts have looked to voidable preference law to undo the kite. Use of this device, ironically, oversteps the goal of sharing losses among *banks*. It expands the notion to benefit nonbank unsecured creditors of *D*. As a result, if voidable preference law works to undo check kiting, the "lucky" bank that is made liable under voidable preference law subsidizes not just the victimized banks but unsecured creditors in general. These unsecured creditors thus benefit from bank robbery.[434]

In fact, voidable preference law is completely inadequate to undo the kite. In our simple example above, suppose *D Bank* collected $100 from *E Bank* and used $90 of it to extinguish the draw on the provisional credits. I resist calling this a "payment," since payment implies unencumbered dollars transferred to satisfy an obligation. Rather, we have a realization of cash collateral, which is governed by Part 6 of Article 9—not by the common law of payment or setoff. Because this is so, *D Bank* has not received a voidable preference. Receipt of proceeds is never a voidable preference.

It is often claimed that the *E* check is "worthless" and that therefore *D Bank* is not really a secured creditor. But it cannot be gainsaid that the "worthless" check did yield proceeds, and these proceeds ended up in the hands of *D Bank*. The

431. *E Bank*, however, must be able to trace the trust funds into the estate of *D Bank*. Inability to trace turns *E Bank* from a property claimant against *D Bank* into a general creditor of *D*. First Fed. of Mich. v. Barrow, 878 F.2d 912 (6th Cir. 1989).

432. It is not the case, however, that *E Bank* has an adverse claim to the item deposited, U.C.C. § 3-306 (2017), although *D Bank* is a holder of that item. Howell v. Bank of Newnan (*In re* Summit Fin. Servs., Inc.), 240 B.R. 105, 114–15 (Bankr. N.D. Ga. 1999). Until the check is presented the check belongs to *D*, subject to *D Bank*'s security interest on it. Therefore, any talk of *D Bank* taking free of *E Bank*'s property interest in the check is inappropriate. In *Montgomery*, the court assumed the constructive trust was absent, indicating that perhaps *D Bank* was a good faith purchaser for value.

433. *See* 11 U.S.C. § 541(d) (2012) ("Property in which the debtor holds, as of the commencement of the case, only legal title and not an equitable interest . . . becomes property of the estate . . . only to the extent of the debtor's legal title to such property, but not to the extent of any equitable interest in such property that the debtor does not hold."). On the hostile relationship between constructive trust and voidable preference theory, see Southmark Corp. v. Grosz (*In re* Southmark Corp.), 49 F.3d 1111, 1117 (5th Cir. 1995); McLemore v. Third Nat'l Bank (*In re* Montgomery), 983 F.2d 1389, 1393 (6th Cir. 1993); Pereira v. United Jersey Bank, N.A., 201 B.R. 644, 679 (S.D.N.Y. 1996); Carlson & Widen, *supra* note 67, at 630–31.

434. The fact this is true is a major hint that check kiting is no fraud on D's unsecured creditors. *See infra* text accompanying notes 499–506.

kited check was indeed far from worthless.[435] The fact that it resulted in *D Bank* receiving cash collateral precludes any voidable preference theory. This is basically the position reached in the *Laws* litigation.[436]

In spite of these observations, an early case from the Sixth Circuit insisted that check kiting gives rise to voidable preference liability for the "lucky bank" that survives the kite. In *In re Montgomery*,[437] the bankruptcy court strove mightily to prove that *D Bank* was the victim of a theft (even though lucky *D Bank* escaped by collecting from *E Bank*). Because *D* committed a tort against *D Bank* when *D* withdrew $90 against provisional credits, *D Bank* was a creditor of *D*, and *D Bank* was paid on antecedent debt when *E Bank* honored the check *D Bank* presented to *E Bank*.

This struggle to demonstrate that *D* was a tortfeasor against *D Bank* was completely unnecessary. When *D* withdrew the $90, *D Bank* was then a creditor of *D*. This conclusion, however, is contradicted by the world view of the *Laws* court. According to the *Laws* view, withdrawing $90 by *D* did not create a debt. There never *was* a debt, according to *Laws*, because the deposited item was successfully collected. Ergo, if *Laws* is correct (which it is not), then the tort theory in *Montgomery* was necessary after all to demonstrate the existence of an antecedent debt. The *Montgomery* court thus implicitly adopted the dubious *Laws* position on the nature of withdrawals against provisional credits.[438]

---

435. Carlson, *Crucible*, *supra* note 30, at 282. According to the court in *Laws v. United Missouri Bank of Kansas City, N.A.*:

> The trustee urges a different result because [*D*] was allegedly kiting checks and kited checks are worthless. But as the district court noted, the deposited checks in an on-going check kite are not worthless, though some may be if the kite collapses. The trustee's theory finds no support in the language of § 547(b) of the Bankruptcy Code and Article 4 . . . . In these circumstances, we agree with the district court that [*D Bank*] was a fully secured creditor.

98 F.3d 1047, 1052 (8th Cir. 1996), *cert. denied*, 520 U.S. 1168 (1997); *see also In re* Brown, 209 B.R. 874, 887 (Bankr. W.D. Tenn. 1997).

436. Valuations may occur in overdraft cases where a cash deposit (not an encumbered item) eliminates the overdraft. *See supra* text accompanying notes 341–58.

437. 123 B.R. 801 (Bankr. M.D. Tenn. 1991), *aff'd*, 136 B.R. 727 (M.D. Tenn. 1992), *aff'd*, 983 F.2d 1389 (6th Cir. 1993).

438. In order to overcome the obstacle caused by the *Laws* reasoning, the bankruptcy court struggled to show that *D Bank* was estopped from denying it was a creditor for the advances against the provisional credit. To understand the use of the estoppel concept we need to delve into the complicated facts of *Montgomery*.

In the beginning of its relationship with *D*, *D Bank* insisted that the debts for withdrawals from provisional credits be secured by a real estate mortgage, with a maximum exposure of $500,000. Just before bankruptcy, this line of credit had been exhausted and *D Bank* reimbursed itself by collecting the proceeds of deposited items. To prove that *D Bank* was a creditor of *D*, the court remarked:

> The conduct of [*D Bank*] in this case would estop the Bank to deny it had a right to payment for the use of uncollected funds. The $500,000 line of credit was a conventional loan. By contract . . . "ledger overdrafts" caused by [*D Bank*'s] use of uncollected funds . . . were covered by draws against this authorized loan until its exhaustion. That [*D Bank*] immediately converted the use of uncollected funds . . . into conventional debt by draws against the line of credit demonstrates the Bank's perception and intent that the use of uncollected funds . . . rendered [*D*] the Bank's debtor. This debtor/creditor relationship continued after exhaustion of the line of credit—only the accounting technique changed. Instead of drawing against the line of credit, the Bank

What is missing from *Montgomery* is recognition that *D Bank* is a secured creditor.[439] The deposited *E Bank* check is valid collateral and *D Bank* effectively realized or "foreclosed" on this collateral.[440] On our example, *D Bank* validly applies $90 to the secured debt and returns the $10 surplus to *D*. Because *D Bank* receives cash proceeds of valid collateral, *D Bank* has received no voidable preference.[441]

The *Montgomery* courts obsessed over whether successful exit from a check kite diminishes the bankruptcy estate to the prejudice of the unsecured creditors. A fair answer to this question is: Who cares? We're reading section 547(b)![442] Indeed the notion that a voidable preference must reduce the bankruptcy estate seems to be describing the hypothetical liquidation test of section 547(b)(5).[443] It is that provision we should be reading. And where the surviving bank reimburses itself by realizing on its section 4-210(a) security interests on items, the terms of this test cannot possibly be met. Receipt of collateral always flummoxes the hypothetical liquidation test.

> account for its right of payment from [*D*] by calculating average, negative collected balances and assessing [interest charges] each month.

Id. at 811. If the *Laws* analysis is rejected, such an exercise in estoppel would have been unnecessary.

439. Howell v. Bank of Newnan (*In re* Summit Fin. Servs., Inc.), 240 B.R. 105, 118 (Bankr. N.D. Ga. 1999) ("*Montgomery* is not that helpful because it contains no discussion of a bank's security interest in deposited items." (footnote omitted)); *In re* Brown, 209 B.R. 874, 889 (Bankr. W.D. Tenn. 1997) ("this court does not find *Montgomery* to be controlling or particularly instructive on the issue of the secured status of these defendant banks").

440. U.C.C. § 4-210(c) (2017).

441. It is not possible to reconstruct the exact nature of *D Bank*'s $2,254,935 liability in *Montgomery*. Most of this amount ($2,012,418) must have consisted of collections from deposit items and therefore should not have resulted in liability at all. *D Bank* was also held liable for $242,517 for the paydown of the $500,000 line of credit referred to in *supra* note 439. 136 B.R. at 729. This $242,517 paydown was not preferential for two reasons. First, it seemed to have been accomplished by applying cash proceeds received from collecting deposited items. Applying cash proceeds to antecedent debt is never preferential (so long as the original security interest is valid). Second, *D Bank* was a fully secured creditor, when the real estate was added to the proceeds of collected items in the deposit account. Payment to an oversecured creditor is never preferential.

Finally, cashier's checks totaling $320,000 were deposited with *D Bank* in order to cover deposited checks *D Bank* could not collect. *Id.* at 806. These deposits would appear to be transfers on antecedent debt in favor of *D Bank*, but it seems that at all times *D Bank* was oversecured. It is hard to see how transfers to an oversecured creditor can be voidable preferences.

On appeal, *D Bank* complained that the bankruptcy court had failed to describe precisely which transfers it was avoiding (which would seem to be a fair complaint). Both the district court and the court of appeals ruled that the bankruptcy court had been specific enough. *Id.* at 731–33.

442. In *Montgomery*, the trustee argued to the district court that diminution of the bankruptcy estate is immaterial and not required by the statute. The district court criticized the trustee for this impious heresy, citing gospel of *Collier*, which holds otherwise. *Id.* at 734 ("The trustee's claim that the diminution of the estate test is inapplicable . . . is in direction opposition to the opinion of this Court . . . ." (citing *In re* H&S Transp., 110 B.R. 827, 833 (M.D. Tenn. 1990))).

443. Abramson v. St. Regis Paper Co. (*In re* Abramson), 715 F.2d 934, 938 (5th Cir. 1983) ("There is no statutory requirement [in the 1898 Act] that there be a diminution of the estate. However, such a requirement is implicit in the language of the statute . . . ."); *In re* Hudson Valley Quality Meats, Inc., 29 B.R. 67, 78 (N.D.N.Y. 1982) ("The concept of 'depletion of the estate' while not strictly an element of a preferential transfer under § 60a of the Bankruptcy Act has nevertheless been engrafted thereon by the courts." (footnote omitted)).

Nevertheless, *D Bank*'s appeal in *Montgomery* was founded precisely on this ground. In its appeal, *D Bank* insisted that it had not diminished the bankruptcy estate. In effect, both courts on appeal said that *exiting the kite* is precisely a diminution of the estate.[444] But this is not the case. What we observe in a check kite is that *E Bank* replaces *D Bank* as a creditor and the estate is not diminished. Alternately, one may observe that the kited check was valuable, but *D Bank* traded exactly $90 for it. The security interest on the kited check was a contemporaneous exchange, and so the debtor's estate was not diminished.

In any case, the Sixth Circuit essentially reversed itself as to kites.[445] In *First Tennessee Bank, N.A. v. Stevenson (In re Cannon)*,[446] the court recognized that, in a kite, the bank that obtains proceeds of deposited items receives cash collateral and therefore cannot possibly have received a voidable preference. *Montgomery* was distinguished because the bank in that case had *knowledge* of the kite when it escaped, whereas, in *Cannon*, the bank had *no knowledge* and was simply lucky in its escape. According to the *Cannon* court:

> Thus, while *Montgomery* provides guidance for situations where the depositary or collecting bank acts with knowledge of the kiting scheme, it does not control situations such as the case at bar where the bank acts in the ordinary course of business, without knowledge of questionable banking practices by its account holder.[447]

In fact, even the *knowledgeable* bad-faith bank receives cash proceeds in a kite. Section 547(b)(5) does not care whether the creditor is in good faith or bad faith. Bad faith might give rise to a constructive trust claim for the victimized bank, but it does not give rise to a voidable preference. Not every commercial sin is remedied by Bankruptcy Code section 547(b).

IV. Is Check Kiting a Fraudulent Conveyance?

Although this article focuses on voidable preference law, the question has arisen whether escaping the kite is a fraudulent conveyance. The answer to this question is a decisive "no."

In the discussion that ensues, we assume that *D Bank* is aware of the kite when it presents the kited item to *E Bank* for payment. Since *E Bank* voluntarily conveys cash equivalents to *D Bank*, *E Bank*'s remedy, if any, lies in constructive trust. If *D Bank* has no knowledge of the kite, then *D Bank* is a good faith purchaser for value of the cash equivalents, and *D Bank* buys *E Bank*'s equity in the trust free and clear. Thus we consider only banks that exit the kite with guilty knowledge.

444. 136 B.R. at 734 (*D Bank* "extricated itself from the scheme when it deemed the risk to exceed the reward. Under these conditions, where a legitimate real estate business was financed by a check kite, this Court concludes that [*D*'s] estate was indeed diminished by the illegal check kiting activity.").

445. *See* Clark & Clark, *supra* note 12, § 9.06, at 9-29, 9-31.

446. 237 F.3d 716 (6th Cir. 2001).

447. *Id.* at 720.

Even if *D Bank* knows that it is presenting a kited check, *E Bank*'s payment is not a fraud on *D*'s creditors. Indeed, the kite is the *opposite* of this. If the kite succeeds, the creditors are positively enriched, because the debtor's estate increases. How can such an enrichment be a fraud on the people who are enriched? A constructive trust exists to prevent this result. What a constructive trust theory achieves is restoration of the *status quo ex ante*. In a constructive trust, unsecured creditors are denied a windfall share of the loot.[448] The view that the kite is a fraudulent conveyance constitutes robbery from *E Bank* for the benefit of the bankruptcy estate.

In *Pioneer Liquidating Corp. v. San Diego Trust & Savings Bank (In re Consolidated Pioneer Mortgage Entities)*,[449] the trustee[450] unsuccessfully claimed that a knowing exit from the kite was a fraudulent conveyance.[451] The reason given to acquit *D Bank*, however, is most unsatisfactory. According to the *Pioneer* court, check kiting involves no transfer of debtor property at all!

The *Pioneer* court observes that, notwithstanding the Bankruptcy Code's broad definition of "transfer,"[452]

> it is well settled that a customer's bank deposits into its own unrestricted checking account are not transfers within the meaning of the Bankruptcy Code. When the customer makes a deposit, the bank substitutes a credit for the deposited . . . items. This substitution differs from a transfer because the customer continues to have the right to withdraw the deposited funds.[453]

---

448. Stevenson v. J.C. Bradford & Co. (*In re* Cannon), 277 F.3d 838 (6th Cir. 2002) (a showing that D gave away trust property precluded a finding that the transfer was fraudulent as to creditors).

449. 211 B.R. 704 (S.D. Cal. 1997), *aff'd in part & rev'd in part on other grounds*, 166 F.3d 342 (9th Cir. 1999).

450. Or, to be more precise, a successor to the trustee.

451. *See also* Colonial Bank v. Freeman (*In re* Pacific Forest Prods. Corp.) 335 B.R. 910 (S.D. Fla. 2005) (authorizing interlocutory appeal where bankruptcy court held that exiting a kite involved an intentional fraud on creditors).

452. *See* section 101(54), defining a transfer as

> (A) the creation of a lien;
>
> (B) the retention of title as a security interest;
>
> (C) foreclosure of the debtor's equity of redemption; or
>
> (D) each mode, direct or direct, absolute or conditional, voluntary or involuntary, of disposing of or parting with—
>
> (i) property; or
>
> (ii) an interest in property.

11 U.S.C. § 101(54) (2012). This definition is the product of the 2005 amendments to the Bankruptcy Code. Pub. L. No. 109-8, § 1201(2), 119 Stat. 23 (2005). Prior to 2005, the definition of "transfer" was

> every mode, direct or direct, absolute or conditional, voluntary or involuntary, of disposing of or parting with property or with an interest in property including retention of title as a security interest and foreclosure of the debtor's equity of redemption.

Pub. L. No. 95-598, § 101(54), 92 Stat. 2549 (1978); Barnhill v. Johnson, 397, 393 (1992).

453. Pioneer Liquidating Corp. v. San Diego Trust & Sav. Bank (*In re* Consolidated Pioneer Mortg. Entities, Inc.), 211 B.R. 704, 714–15 (S.D. Cal. 1997), *aff'd in part & rev'd in part on other grounds*, 166 F.3d 342 (9th Cir. 1999) (citations omitted).

Far from being "well settled,"[454] the premise that bank deposits are not transfers to the bank must be rejected decisively. When *D* approaches the teller window at *D Bank* intending to deposit cash, *D* owns that cash. When *D* deposits the cash and receives a credit withdrawable as of right, *D* ceases to be the owner of the cash and *D Bank* becomes the owner of the cash.[455] Thus there has been a transfer of cash. True, the bank exchanges its promise to pay for the cash, which in normal times is the exact equivalent of the cash.[456] Accordingly, the transfer is a contemporaneous exchange and not a voidable preference or fraudulent transfer. But it is a transfer all the same.

The court continues:

> Because the depositor has the right to withdraw the deposited funds, the deposit does not deplete the depositor's estate. Although the customer "disposes of" or "parts with" the deposited items in exchange for the credit, this "parting" is not a transfer for bankruptcy purposes because, in effect, the assets available to the customer have not changed.[457]

---

454. For its "well settled" proposition, the *Pioneer* court cites *New Jersey National Bank v. Gutterman (In re Applied Logic Corp.)* 576 F.2d 952, 962 (2d Cir. 1978), which indeed proclaims that bank deposits are not transfers. *Applied Logic*, in turn, cited (and *Pioneer* likewise cited) *New York County Bank v. Massey*, 192 U.S. 138, 145 (1904), discussed *supra* in the text accompanying notes 247–53. The *Massey* court ruled that a bank deposit is not a voidable preference because the deposit does not diminish the bankruptcy estate (in those days an inferred requirement of the statute). *Massey* certainly does not hold that bank deposits are not transfers. It holds they are not *voidable* transfers. Meoli v. Huntington Nat'l Bank (*In re* Teleservices Grp., Inc.), 469 B.R. 713, 745 (Bankr. W.D. Mich. 2012) ("the [*Massey*] court never said that customer deposits were not transfers"), *rev'd*, 848 F.3d 716 (6th Cir. 2017). According to the legislative history, "[a] deposit in a bank account . . . is a transfer." S. REP. No. 95-989, at 27 (1978); *but see Meoli*, 848 F.3d 716 (holding that deposits of fraudulently transferred funds were not transferred to the depositary bank, even though the bank had notice of a Ponzi scheme); John C. McCoid, II, *Setoff: Why Bankruptcy Priority?*, 75 VA. L. REV. 15, 26 (1989) (the *Massey* court "found that deposits within the vulnerable period (then four months) were not transfers" (footnote omitted)).

The *Pioneer* court also cites the following: Citizens Nat'l Bank v. Lineberger, 45 F.2d 522, 527 (4th Cir. 1930) ("[a]n ordinary deposit in a bank, however, is not a 'transfer' within the meaning of [the voidable preference] section"). The 1898 Act, at that point, defined "transfer" as "the sale and every other and different mode of disposing of or parting with property, or the possession of property . . . as a payment." Bankruptcy Act of 1898 § 1(25). The *Lineberger* court states that "[a] deposit in a bank is not a sale or parting with property . . . as a payment." 45 F.2d at 527. But surely, even if it is not a *voidable* transfer, it is a *transfer* of money to the bank in exchange for the bank's promise to pay it back.

455. Crocker-Citizens Nat'l Bank v. Control Metals Corp., 566 F.2d 631, 637 (9th Cir. 1977) ("when funds are deposited, title to those funds passes immediately to the bank" (citations omitted)).

456. *Meoli*, 469 B.R. at 740 ("every deposit by a bank's customer is for value because by definition it is accompanied by a corresponding promise from the bank that it will repay the same upon the customer's demand"); *cf.* Bernard v. Sheaffer (*In re* Bernard), 96 F.3d 1279, 1283 (9th Cir. 1996) ("Instead of owning money sitting in their accounts, the [debtors] owned claims against their bank. When they withdrew from their accounts, they exchanged debt for money . . . .").

457. 211 B.R. at 715. "Disposes of" and "parting with" paraphrases the Bankruptcy Code's definition of "transfer" in 11 U.S.C. § 101(54) (2012). The court of appeals held that the bank's security interest on the item did not deplete the bankruptcy estate. *In re* Pioneer Liquidating Corp., No. 97056238, 1999 U.S. App. LEXIS 517, at *4 (9th Cir. Jan. 12, 1999). This is correct. The bank bought the item for its value by allowing the draw on the provisional credit. Then the bank collected. There was no net negative effect on the bankruptcy estate.

This passage makes it clear that the court is defining "voidable" transfers, not "transfers" straight up. And even so, the definition is inaccurate. A transfer for fair consideration can be a transfer that hinders, delays, or defrauds creditor. A bulk sale of inventory is the classic example.[458] If the transferee is not a good faith purchaser, the creditors can reach the transferred property even though the creditor paid for it. On the court's definition, a bulk sale can never be a fraudulent transfer because the buyer (with knowledge of the fraud) has paid value.

The *Pioneer* court draws from its bad definition the principle that creation of a U.C.C. section 4-210(a) security interest in a kited check is not a transfer:

> For similar reasons the U.C.C. security interests in deposited checks that arises in favor of the bank when the customer withdraws provisionally credited funds is not a transfer. The security interest does not deplete the depositor's estate or change the assets otherwise available to creditors. The security interest does not impede the customer's control over how to spend the deposited funds. The security interest is a "temporal interest" that does not burden the customer. On the contrary, the security interest operates as a benefit to the customer, rather than a burden, because it enables the customer to enjoy immediate access to the deposited funds. Creation of the security interest is what enables the deposit. The security interest is not a "parting" with property because the customer gets access to substituted funds in exchange.[459]

It should not be controversial that the creation of a security is *always* a transfer from the debtor to the creditor. After 2005, the federal definition of transfer includes "the creation of a lien"[460] The creation of the section 4-210(a) security interest may be a transfer in exchange of an equivalent value, but it is a transfer all the same.

With regard to check kiting, the *Pioneer* court's intuition is ultimately correct. Suppose *D* deposits a kited check drawn on *E Bank*. *D Bank* strongly suspects the kite and, wishing not to be caught holding the tail, presents the check to *E Bank* without disclosing its suspicion. This cannot be a fraud on *D*'s creditors. In fact, *D*'s creditors are delighted to be enriched by the proceeds of the provisional credit. If *E Bank* ends up holding the tail, there has been a wrong, not to *D*'s

458. David Gray Carlson, *Bulk Buyers Under Article 9: Some Easy Cases Made Difficult*, 41 Ala. L. Rev. 729 (1990).

459. 211 B.R. at 715. The court even observes, "The security interest is a liability for the bank because of the possibility that the payor banks will not honor the deposited checks." *Id.* at 715 n.13. This is like saying that having a $100 bill is a liability because it may be counterfeit. Few persons would be persuaded by this logic to throw away their wallets.

Particular note should be taken of this passage from *Pioneer*: "Because the creation of the security interest does not require the customer to surrender an interest that it could otherwise retain, the creation of the security interest is not a transfer." *Id.* at 715. Indeed the opposite is true. Concededly, if *D* never drew down the provisional credit, *D Bank* is merely *D*'s agent for the purpose of collection. As agent, *D Bank* has a duty to follow instructions with regard to the deposited item. So *D Bank* must give back the check to *D* if *D* changes her mind and does not want *D Bank* to present the check for payment. This changes drastically if *D* draws down the provisional credit. If *D Bank* permits such a draw, a security interest arises by operation of law. *D Bank* is now an agent coupled with an interest. *D Bank* need not follow *D*'s instruction anymore. *D Bank*'s right to possess the item is rightful against *D*. Therefore, creation of the security interest *does* require the customer to surrender the item, and *D* may *not* "otherwise retain" this item over the opposition of *D Bank*.

460. 11 U.S.C. § 101(54)(A) (2012).

creditors, but to *E Bank*, and *E Bank* has an argument that *D Bank* has taken *E Bank*'s funds in constructive trust.[461] If there is a remedy for check kiting, it belongs to *E Bank* and not to *D*'s bankruptcy trustee.

One may even question, as did the *Pioneer* court,[462] whether *D Bank* has obtained funds by fraudulent means. The reason that *E Bank* paid *D Bank* is because *E Bank*'s customer (who may or may not be D) deposited a check with *E Bank* and received a provisional credit. *E Bank*'s payment to *D Bank* constitutes a draw on the provisional credit. After paying *D Bank*, *E Bank* hopes to collect the deposited item. So far as *D Bank* knows, the payor bank of the item deposited with *E Bank will be paid* and the kite will continue. Arguably, *D Bank* does not know for certain that the kite will crash.[463] To date, the law has not imposed on *D Bank* a duty to share its suspicions with *E Bank*.[464] There are few cases in which *E Bank* or *E Bank*'s customer has successfully obtained judicial recognition that *D Bank* is constructive trustee for *E Bank*.[465]

For our purposes we leave off the matter as follows: *if* someone has a remedy against *D Bank* for knowingly exiting the kite, this is a remedy that belongs to *E Bank*, not to *D*'s bankruptcy trustee.

CONCLUSION

This article has surveyed the law of voidable preferences as applied to depositary banks. It has found that, although courts intuit the right results by and large, they have not yet found the proper vocabulary to poetize their intuitions.

Basically, there is a divide between cases involving overdrafts and cases involving draws on provisional credits. The overdraft cases present the real risk of voidable preference liability for banks. Generally, the cases have not paid attention to whether reimbursements are via payment of unencumbered dollars

461. In affirming the district court's finding of no fraudulent transfer, the Ninth Circuit held that realization of *D Bank*'s security interest in kited items did not diminish the bankruptcy estate. Pioneer Liquidating Corp. v. San Diego Trust & Sav. Bank (*In re* Consolidated Pioneer Mortg. Entities, Inc.), No. 97-56238, 1999 U.S. App. LEXIS, at *4 (9th Cir. Jan. 13, 1993). This much is true, but other aspects of the opinion cast doubt on whether the court had any understanding of the case at all. According to the Ninth Circuit, *D Bank* was not a transferee of *D*'s property because *D Bank* had no control over how the provisional credits would be used. It was therefore a "mere conduit." *Id.* at *4. This remark is aimed at deposits of kite items. But what the trustee was seeking was recovery of *collections* of kite items. As to collections (which *D Bank* kept for itself), *D Bank* was no mere conduit but was absolute owner of these funds. Equally wrong was its adoption of the *Laws* analysis: The advance on provisional credits were not loans. *See supra* text accompanying notes 288–335. Such an endorsement is not only wrong but counterproductive. If *D Bank* was not a creditor of *D*, then its receipt of funds from *E Bank* (property of *D* because *E Bank* was advancing funds to *D*) were gratuitous transfers and hence fraudulent transfers—the opposite of what the 9th Circuit intended.

462. 211 B.R. at 715.

463. The matter is different if *D Bank* knows *E Bank*'s provisional credit is based on a check drawn on *D Bank* that *D Bank* intends to dishonor.

464. Frost Nat'l Bank v. Midwest Autohaus, 241 F.3d 862, 865–66 (7th Cir. 2001); Alta Vista State Bank v. Kobliska, 897 F.2d 160 (8th Cir. 1990); Citizens Nat'l Bank v. First Nat'l Bank, 347 So. 2d 964 (Miss. 1977).

465. *See* Lyons v. Jefferson Bank & Trust, 793 F. Supp. 981 (D. Colo. 1992). For a survey of constructive trust and other possible remedies of private parties, see *Pereira v. United Jersey Bank, N.A.*, 201 B.R. 644 (S.D.N.Y. 1996). The case is grim reading for aggrieved third parties.

(basically wire transfers), setoffs and realization on collateral. Analytically, much turns on the nature of the transfer, yet courts have not been careful with these distinctions.

In overdraft cases where unsecured credit is extended, many defenses are available and they have all been analyzed here. In particular, I have examined whether the depositary bank may claim a statutory lien on deposited items. I have also suggested that a depositary bank is entitled to the section 547(c)(5) defense pertaining to receivables, since a deposit account is a receivable as the Bankruptcy Code defines that term.

In the case of draws on provisional credits, secured credit is extended, and these tend not to be risky. Where the reimbursement is in the form of a cash deposit or wire transfer, as opposed to a deposited check, there are unexpected traps for the depositary bank which this article has thoroughly analyzed.