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Recommended Citation
William E. Hogan, Games Lawyers Play with the Bankruptcy Preference Challenge to Accounts and Inventory Financing, 53 Cornell L. Rev. 553 (1968).
Available at: http://scholarship.law.cornell.edu/clr/vol53/iss4/1

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GAMES LAWYERS PLAY WITH THE BANKRUPTCY PREFERENCE CHALLENGE TO ACCOUNTS AND INVENTORY FINANCING

William E. Hogan†

I

INTRODUCTION

Much ink has been put to paper concerning the effect of the preference provisions of the Bankruptcy Act upon the Uniform Commercial Code's provisions for financing accounts receivable and inventory. In the face of so much erudition, one hesitates to add to the bibliography. Yet, sometimes the technical focus of the discussion tempts one to raise other kinds of issues. Resistance to that temptation became impossible for this writer with the decision in In re Portland Newspaper Publishing Co. Judge Solomon's opinion injects a welcome note of pragmatism into a dispute previously characterized by the intricate analyses good lawyers do so well. Of course, any competent craftsman enjoys a sense of satisfaction from a closely reasoned analysis of the interrelations of two complex statutes. It is fun and often like a game. Yet, as Judge Solomon indicates, legal gamesmanship does not by itself produce the standards needed in the marketplace.

The facts generating the discussion are easy to state, but the resulting legal problem is difficult to resolve. In 1959 various striking newspaper unions in Portland, Oregon, organized a company to publish The Reporter, a daily newspaper, to compete with the two existing


newspapers. Another company, Rose City, was formed to acquire buildings to house *The Reporter*. Rose City loaned $45,000 to *The Reporter* on November 16, 1963, and another $10,300 on November 22. On the latter date, the parties entered into a security agreement that gave Rose City a security interest in all *The Reporter's* accounts "now existing or hereafter arising." An appropriate financing statement was duly filed on November 26, 1963. Financial difficulties led friends of *The Reporter* to take various additional actions, including a merger, to infuse life into the newspaper. The efforts failed, and on September 23, 1964, Rose City took steps to collect the accounts. On October 15, 1964, an involuntary petition in bankruptcy was filed by other creditors, and shortly thereafter the successor corporation publishing *The Reporter* was adjudicated a bankrupt.

Law then took over, and the theme soon became "woe unto the lender." The trustee asserted that Rose City's claim to all accounts arising within four months prior to bankruptcy constituted a voidable preference. The Referee in Bankruptcy agreed with the trustee in an eloquent and literate opinion.²

Rose City had taken each and every action that the Uniform Commercial Code requires of a creditor seeking to obtain a security interest in accounts. The debtor had apparently signed a written agreement,³ providing Rose City with a security interest in collateral described as all the accounts receivable both "now existing or hereafter arising."⁴ A financing statement in appropriate form had been filed properly.⁵ Moreover, these steps had been taken long before the petition in bankruptcy was filed. It is true that Rose City had failed to take some steps a professional lender might have taken, but Rose City simply was not a professional. No routine was established for policing the accounts, as by routing collections through a bank account in Rose City's name, but UCC Section 9-205 clearly destroys the notion that the debtor's control or dominion over the collateral makes the transfer fraudulent as to his creditors.⁶ No supplementary schedules of assigned accounts

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³ Uniform Commercial Code § 9-203 [hereinafter cited as UCC].
⁴ UCC § 9-110.
⁵ UCC §§ 9-401, 9-402.
⁶ As is so often the case, Grant Gilmore has best described the effect of § 9-205: "No one can doubt that this does the job. Twyne's Case is finally undone. Benedict is dead and Ratner is king. 'Dominion' by the debtor is no longer 'inconsistent' with the nature of security." 1 G. GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY § 11.6 at 358 (1965) (footnote omitted).
were to be prepared and sent to the creditor periodically, but the Code also explicitly eliminates the need for such paper work.\textsuperscript{7}

When all the other requisites for an enforceable security interest are satisfied, that security interest attaches and is perfected as soon as the debtor has rights in the collateral.\textsuperscript{8} The Code provides also that the debtor acquires no rights in an account until it comes into existence.\textsuperscript{9} Apparently, life is breathed into an account when the debtor has a "right to payment for goods sold or leased which is not evidenced by an instrument."\textsuperscript{10} Thus, whenever The Reporter earned a right to payment from its sales, Rose City's security interest was perfected in that account.\textsuperscript{11}

When a transaction is tested against the bankruptcy trustee's power to avoid a preference, the usual starting point is to list the elements of the voidable preference. One can say, in a deceptively simple fashion, that the trustee must show (1) a transfer of the debtor's property, (2) to or for the benefit of a creditor, (3) for or on account of an antecedent debt, (4) made or suffered by the debtor while insolvent, (5) within four months before the filing of the petition initiating the proceeding, (6) the effect of which transfer enables the creditor to obtain a greater percentage of his debt than some other creditor of the same class, and (7) that the creditor knew or had reasonable cause to believe that the debtor was insolvent at the time of the transfer.\textsuperscript{12}

After the Referee found that Rose City had reasonable cause to know of The Reporter's insolvency, the issues were reduced to two. First, did the transfer of the accounts take place within the perilous four month zone prior to bankruptcy? Second, was that transfer for or on account of an antecedent debt? The trustee, of course, needed

\begin{itemize}
\item \textsuperscript{7} UCC § 9-205. See also UCC § 9-204, Comment 4.
\item \textsuperscript{8} UCC §§ 9-204, 9-303. See also UCC § 9-204, Comment 4.
\item \textsuperscript{9} UCC § 9-204(2)(d).
\item \textsuperscript{10} The source of the obligation assigned to Rose City is not clear. If the obligation arose from the sale of advertising space rather than the sale of papers, the classification of the collateral seems obscure. Unless the sale of advertising space is the sale of a service, the collateral might not be an "account." Rather, it would be either a contract right or a general intangible. UCC § 9-106. Would this argument make the description of the collateral in the security agreement adequate?
\item \textsuperscript{11} If the collateral is a general intangible, see note 10 supra, the Code rules might permit earlier attachment and perfection, since UCC § 9-204 does not specifically define when "rights" arise with respect to general intangibles.
\item \textsuperscript{12} Bankruptcy Act §§ 60a(1), b, 11 U.S.C. §§ 96(a)(1), (b) (1964); see Seligson, Preferences Under the Bankruptcy Act, 15 Vand. L. Rev. 115, 115-17 (1961). The four month period is of obscure origin, but apparently it is a compromise between different periods used in other similar statutes. Riesenfeld, The Evolution of Modern Bankruptcy Law, 31 Minn. L. Rev. 401, 421-27 (1947).
\end{itemize}
an affirmative answer to both questions in order to establish that Rose City had received a preference. Obviously, the two questions are interrelated; one must know when the transfer occurred in order to decide whether it occurred within the four month period and whether the consideration was an antecedent debt.

Since 1950, Section 60a of the Bankruptcy Act has provided that a transfer of personal property occurs, for purposes of the preference rules, when it becomes “so far perfected that no subsequent lien upon such property obtainable by legal or equitable proceedings on a simple contract [can] become superior to the rights of the transferee.”

Now the stage is set for a review of the intricate games lawyers play so skillfully, whether they speak for the secured creditor or the trustee, when they first attempt to ascertain the time when the transfer of accounts and inventory occurred and then whether that transfer was for an antecedent debt.

II

ATOMS AND MOLECULES

This game provided the basic premise of the referee’s rejection of Rose City’s secured position; the trustee nearly always wins. Leaning heavily on the Code rules detailing when a security interest attaches and becomes perfected, the trustee asserts that the Code plainly provides that no security interest can attach or be perfected until a specific account comes into existence. Since the Code itself atomizes the collateral, each separately arising account is considered to be separately transferred at the specific time when the debtor obtains rights in the collateral. The Code rules on the attachment and perfection of

16 Why the law cannot recognize present legal arrangements as encumbering later-arising personal property is a mystery. All the issues concerning the relative rights of the secured creditor and his various adversaries could have been resolved by the Code drafts- men without reference to when the debtor obtained rights in the collateral. In fact, this was done in the case of competition among secured lenders who have filed. UCC § 9-312(5)(a). Perhaps the study of law somehow conditions people to believe in the absolute necessity of their acquired assumptions. If there can be no present legal transfer of future goods under that old casebook chestnut, Low v. Pew, 108 Mass. 347 (1871), there must be
the security interest are thus made responsible for the trustee's victory.\textsuperscript{17}

Rose City might have battled the trustee at this very point. If the Bankruptcy Act controls when the transfer occurs, we must look to the timing test provided in section 60a. The transfer of personal property is deemed made when it is so far perfected that no subsequent lien creditor could have acquired rights superior to the transferee.\textsuperscript{18} Rose City can claim that after the filing of its financing statement no lien creditor could acquire superior rights. Since the account is perfected at the moment it comes into existence, any creditor thereafter levying on it would take subject to the perfected security interest.\textsuperscript{19} On the other hand, if, prior to the existence of the accounts, a lien creditor is permitted to exert his process against the account debtor and is somehow given a right to the account as soon as the account arises, he may tie but not defeat the secured creditor. Consequently, to prevail over Rose City, the trustee must show not only that a garnishing creditor's process can reach after-arising accounts, but also that this process gives the garnishing creditor priority over the secured creditor claiming under his after-acquired property clause.\textsuperscript{20}

As is so often the case, the "simple" federal statutory test of referring an issue to the state law governing the rights of a competing lien creditor proves to be complex. Since enactment of the Code, no state court has been called upon to decide whether a garnishing creditor might receive such a priority. The trustee probably would try to avoid the secured creditor's argument by relying not on section 60a but on the Bankruptcy Act's general definition of "transfer."\textsuperscript{21} Hence,
the secured creditor received his transfer only when his interest was fixed in the after-acquired property.

According to the atomists, section 9-108 is a transparent attempt by states to control the result in federally-governed preference cases by defining when a transfer occurs for an antecedent debt. The section seems more modest when read:

Section 9-108. When After-Acquired Collateral Not Security for Antecedent Debt

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

They contend that the rest of the Code and the Bankruptcy Act adhere to the traditional notion that an account cannot be transferred or become the collateral under a security agreement until the account comes into existence. When bankruptcy occurs, many such accounts will have arisen within four months, and, if the original consideration, a loan, was given before those accounts arose, their transfer was a preference. Finally, since this result follows from federal law, section 9-108 cannot cause a different result.

There are several countermoves for the secured creditor. He can attempt to play “Fat Pig,” “Rivers and Streams,” or “Tit for Tat.”

III

FAT PIG

Still focusing on the timing of the transfer, the game opens by assuming a hypothetical case not involving inventory or accounts receivable financing. More than four months before bankruptcy a chattel mortgage is taken and perfected on a specific pig to secure an advance then

Interest therein, absolutely or conditionally, voluntarily or involuntarily, by or without judicial proceedings, as a conveyance, sale, assignment, payment, pledge, mortgage, lien, encumbrance, gift, security, or otherwise; the retention of a security title to property delivered to a debtor shall be deemed a transfer suffered by such debtor.


22 Their reaction to the section has been aptly described as a “red rag to the § 60 bulls.” G. Gilmore, supra note 6, § 45.6, at 1309.
made. Subsequently, the farmer-mortgagor feeds the pig in order to fatten him for market. Inevitably, the pig grows both in weight and, if the market is favorable, in value. Is the unmortgaged feed given to the mortgaged pig during the four month period prior to bankruptcy a preferential transfer? If the transaction is atomized, one can argue that a preference occurs with each gulp of the feeding pig. Simply stating that conclusion seems so silly that the trustee's position is overwhelmed by a kind of *reductio ad absurdum*. But feeding the pig might properly be classified as an incidence of the classical preference if done in an unusual way and in contemplation of bankruptcy. Without too much imagination one can conceive of the debtor diverting especially valuable feed to the pig in order to speed its growth and thereby enhance the value of the collateral for the inadequately secured creditor. Despite the practical difficulties in segregating the amount of the increase in the pig's value attributable to this diversion, the debtor has engaged in the kind of conduct that classical preference law condemns. The unusual diversion of the bankrupt's assets to a single creditor upsets the balance sought by bankruptcy distribution.

IV

**RIVERS AND STREAMS**

In a more sophisticated version of Fat Pig, the ontologically oriented secured creditor may find comfort in the game founded upon the philosophy of change of Heraclitus.

"We step and we do not step into the same river; we are and we are not."  
"You cannot step twice into the same river."  
"All things flow; nothing abides."

These epigrams forecast an answer to the arguments asserted in Atoms and Molecules. Again, the players in this game are concerned principally with the timing of the transfer. In the *Portland* case, the interest of Rose City is regarded as having been transferred at the time of perfection of the interest in the initial batch of accounts receivable, because the collateral consists of the accounts as an aggregate or an entity. Changes in the constituents of

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23 The horse has been used before as an analogy. *See 1 Coogan, Hogan & Vagts, supra* note 15, § 13.07[3][c]. The pig simply seems more appropriate.  
25 Fragment 41, *id.* at 76.  
26 *Id.*  
27 The pre-Code analogue is found in *Manchester Nat'l Bank v. Roche*, 186 F.2d 827.
the entity are not significant, because the entity itself does not change. The secured creditor’s interest is in the stream of accounts flowing through the debtor’s business, not in any specific accounts. As with the Heraclitean river, although the accounts in the stream constantly change, we can say it is the same stream.

Viewing accounts receivable or inventory financing by focusing on the totality of the collateral rather than on each individual item is plausible, but certainly not necessary. Both the businessman debtor and the professional lender probably view the collateral in this way. Surely neither would be concerned if a few accounts ripen into old age without being paid. The careful lender will have taken sufficient property so that the ratio of debt to collateral protects him even though some accounts are uncollectible. Of course, a multitude of old accounts in the collateral may suggest that the river is polluted.

Yet, the question remains: is the aggregate idea of collateral adopted by the Uniform Commercial Code? The major obstacle to an affirmative answer is the Code’s demand that the debtor must have “rights in the collateral” before the security interest can attach and be perfected. Nonetheless, even this requirement is consistent with the idea that the “collateral” in which the debtor must have rights is the river of accounts rather than any specific account. In addition, section 9-108 itself can be viewed as an attempt, albeit awkward and artless, to adopt the entity theory of accounts and inventory collateral. The section fails to express the theory because it uses the legalism that the transfer is “deemed” to be taken for new value. Conclusively presuming that something has happened without proof of its occurrence seems, in a way, to be manufacturing facts. Only the Bankruptcy Act can accomplish such miracles.

Whatever conceptual difficulties may be connected with the idea that inventory and accounts receivable are single entities that “stream” through the debtor’s business, the principal concern should be whether


29 Williston, Transfers of After-Acquired Personal Property, 19 Harv. L. Rev. 557, 581 (1906).

30 Riemer, Bankruptcy—Preference—Conflict Between Section 9-108 of Uniform Commercial Code and Section 60(a) of Bankruptcy Act, 70 Com. L.J. 63, 66 (1965).
this conception of the collateral contradicts or interferes with some major policy of the Bankruptcy Act. Is there a significant possibility that the entity theory would be abused if adopted? The theory is too blunt a tool for properly balancing the interests of secured and unsecured creditors, since it may approve the kind of conduct that the preference law historically condemns, i.e., the conscious and deliberate transfer of property to a favored creditor within four months of bankruptcy. How does the theory protect the creditor against the debtor who liquidates other assets to acquire inventory, which feeds the after-acquired property clause of the security agreement and thereby favors an inadequately secured creditor? One might respond that such trickery by the debtor is less likely in accounts financing, because he would have to sell the inventory in order to swell the accounts and would have difficulty finding sufficient customers to cooperate in the schemes of an insolvent. On the other hand, crash or distress sales of inventory might be used to create accounts to feed the after-acquired clause, and a sufficiently low price might well generate customers who would unwittingly aid the debtor in preferring the secured creditor.

Thus, the Rivers and Streams game proves too much. There is no limitation on the ability of the debtor to steer his assets into a form that will feed the mortgage. If there is only a trickle of collateral prior to the four month zone, the debtor has complete power to cause a flood within the period. This result runs afoul of the classic notion of a preference, i.e., a debtor picking out one creditor to be paid on the eve of bankruptcy. The law of fraudulent conveyances may provide a solution to this objection, but it is difficult if not impossible to fit a pure preference into the badges of fraud of Twyne's Case or its modern progeny, the Uniform Fraudulent Conveyances Act.

V

TIT FOR TAT

Technically, the best response to the atomizers is that, even if their theory times the transfer correctly, a careful secured creditor can ensure that his security interests in the various accounts are in exchange for current, rather than antecedent, consideration. The parties can ar-

31 76 Eng. Rep. 809 (Star Chamber 1601).
32 For an illuminating and sensitive discussion of how little more must be added to the facts of preference to establish a fraudulent conveyance, see Judge Dooling's opinion in Leventhal v. Spillman, 234 F. Supp. 207 (E.D.N.Y. 1964), aff'd mem., 362 F.2d 264 (2d Cir. 1966).
33 2 G. Gilmore, supra note 6, § 45.6, at 1315.
range that the newly arising accounts be taken in exchange for the release of rights in earlier accounts. The transfer is taken for the concurrent release of the collateral rather than for the earlier advances, and thus is for a present consideration. Unlike the other games, Tit for Tat concentrates upon whether the transfer is for an antecedent debt.

In *Walker v. Clinton State Bank*, the substitution-of-collateral argument can be seen at work. A dealer in baby chicks periodically sold them to growers, who would execute notes for the price secured by a chattel mortgage on the chicks. The dealer then delivered the "chicken notes" to a bank for a line of credit at the rate of fifty percent of the face value of the notes. When a batch of chicks was ready for market, the grower settled with the dealer, who then obtained the note and mortgage from the bank in exchange for the "chicken note" of another grower. Since in this case there is something tangible to handle and to deliver physically to the bank in exchange for another tangible piece of paper, it is easier to see substitution at work. It is plain to all that the relative positions of the bank and the dealer are unaltered by the exchanges, and that the dealer's other creditors are not harmed by the transactions with the bank.

When the collateral is the highly intangible ordinary account receivable, the substitution is less obvious. When all collections from the accounts are routed into a bank account in control of the secured creditor, and funds are released contemporaneously with a designation of new accounts to the security arrangement, the substitution of new accounts for a new advance or the release of the proceeds collected on the old accounts is more visible and plausible. Prior to the reformation wrought by the Code, this kind of substitution argument could readily be made by the professional lender. He would have taken these same steps to avoid the stigma of *Benedict v. Ratner*, which required the secured creditor to police the collateral or risk losing his secured position entirely. The Code, however, repealed *Benedict v. Ratner*, and, because the doctrine was clearly a matter of state law, there is no foundation for its survival in bankruptcy.

Arguably, section 9-108 only attempts to accomplish what is already done in this substitution theory. Yet, that conclusion states too much from two viewpoints. First, the substitution doctrine may be a

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34 216 F.2d 165 (8th Cir. 1954).
35 268 U.S. 353 (1925).
37 *In re New Haven Clock & Watch Co.*, 253 F.2d 577 (2d Cir. 1958).
creature of federal law, not state law. Thus, section 9-108 may be an attempt to bend bankruptcy results by state legislation in an area where Congress has not left room for the operation of state law even interstitially.\textsuperscript{38} Second, the boundaries for operation of the substitution doctrine are not mapped out. If the "tit for tat" game is to be played under rules requiring exact, simultaneous exchange of accounts of equivalent value, then the theoretically attractive idea of substitution is practically worthless to a secured creditor operating without the policing techniques of the pre-Code \textit{Benedict v. Ratner} era.\textsuperscript{39}

If strict tracing is required, the secured creditor will receive a preference by any transfer of an account within the four month period unless the account is substituted specifically for another account or given to secure a contemporaneous advance. To assure a favorable fact-finding, the lender will be forced to revive the expensive and time-consuming procedures rejected as unimportant and cumbersome by repeal of the state law foundation of \textit{Benedict v. Ratner}. The unsecured creditors as a class will receive no positive benefits from this restoration of policing techniques. All significant accounts receivable transactions must be displayed in a public filing.\textsuperscript{40} Making secured business credit more difficult to extend often means that the debtor will not have sufficient operating funds to pay his unsecured creditors in the usual course.

One substitute for a strict tracing requirement has the virtue of demanding relatively simple administrative supervision during the life of the loan.\textsuperscript{41} The value of the collateral immediately prior to the four month period is compared to the value of the accounts at the date of filing of the petition in bankruptcy. If there has been no net increase in the amount of the collateral, the incoming accounts are considered taken in substitution for the collected accounts. On the other hand, if at the date of bankruptcy the collateral has swollen beyond its value at the beginning of the four month period, the transfer of the excess will be classed as a transfer for an antecedent debt, and a preference may be

\textsuperscript{38} \textit{In re} Pusey-Maynes-Breish Co., 37 F. Supp. 316 (E.D. Pa.), aff'd, 122 F.2d 605 (3d Cir. 1941). Section 60a(8) of the Bankruptcy Act, 11 U.S.C. § 96(a)(8) (1964), explicitly treats security transfers for future loans and future advances as transfers for new and contemporaneous consideration. It is of doubtful help in assaying legislative intent with respect to federal occupation of the field on the question of defining antecedent debt. An argument on either side can be built on this provision.

\textsuperscript{39} This argument is forcefully and thoughtfully developed by Judge Solomon. \textit{In re} Portland Newspaper Publishing Co., 271 F. Supp. 395, 400 (D. Ore. 1967).

\textsuperscript{40} UCC §§ 9-104(5),9-302(1)(c).

found. Under this scheme the secured creditor who continually insists on a relatively safe ratio of debt to collateral will not lose his accounts to the trustee’s claim of a preference. For example, if the debt-to-collateral ratio is maintained at three-to-four, a $75,000 loan will be secured by a security interest in $100,000 worth of accounts. If the value of the accounts during the four month period remains above $75,000, the secured party will still be able to collect his debt from the collateral in an ordinary bankruptcy. But if the collateral is worth only $50,000 at the outset of the four month period, the secured creditor will be limited to that amount even if the accounts are worth $100,000 at bankruptcy. In this case the increase would be considered preferential. On the surface this scheme is easy to administer both for the loan officer and the bankruptcy court. The secured creditors need only make sure that the collateral stays ahead of the loan, and the bankruptcy courts must only decide two fact questions: the value of the collateral at the beginning and at the end of the four month period.

Although this “two point” method of tracing makes for easier administration than either precise tracing or revival of the policing techniques of Benedict v. Ratner, it has a discriminatory premise. Only businesses that have a regular and constant flow of accounts or inventory can safely be financed within its boundaries. If the debtor has fluctuating income, his credit needs will be poorly served. Farmers may thus have an added obstacle to overcome in obtaining credit, because their accounts are earned en masse at the end of the growing season. Other seasonal industries, such as toy manufacturers, suppliers of recreational items, and fashion clothiers, may face this same problem. In addition, expanding businesses in need of capital will find the preference hurdle in their path. Each of these cases involves a situation in which, without any scheme to harm creditors, the value of the accounts may increase during the four months prior to bankruptcy. And in each case, the secured creditor may have planned on the rising accounts as collateral without violating any standard of business morality. If we adopt the “two point” method of tracing as a flat rule, we may reach a workable compromise between the claims of the secured creditor group and the bankruptcy bar. But, without any other reason, we will be

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42 Reorganization under Chapter X of the Bankruptcy Act may present a special peril to the accounts financer if the trustee needs cash and there is a reasonable likelihood of a successful reorganization. Reconstruction Fin. Corp. v. Kaplan, 185 F.2d 791 (1st Cir. 1950); In re Newal, Inc., 239 F. Supp. 430 (D. Mass. 1965).

discriminating against a substantial number of debtors and their secured creditors. Furthermore, because of its ease of administration, the "two point" rule may tempt the debtor to act in a commercially improper way to prefer the secured creditor. If the value of the accounts has been naturally decreasing, the debtor may conduct a crash sale just before bankruptcy and thereby swell the accounts back up to a level reached four months earlier. The "two point" rule of substitution will force the result that no preference has occurred, even though the debtor has worked the classic preference. A comparable scheme can be worked in inventory financing if the debtor zealously purchases goods on an open account basis during the four month period.44

VI
PREFERENCE POLICY AND SECTION 9-108

In finding the transfer to Rose City preferential, the referee conceded that "[t]he wide divergence of opinion gives one pause as to the correct solution."45 No one can quarrel with that remark. It acknowledges that skillful lawyers have fashioned arguments to support each side of the case—arguments technically splendid and admirably marshalled. Yet, within each of the legal webs spun by the disputants is a hidden axiom: that Rose City's claim is or is not the kind of interest that should be avoided by the preference weapon. If clever lawyers can weave legal arguments for either result, should they not also confront the question whether rejection of Rose City's claim serves the purposes of the complex rules of Section 60 of the Bankruptcy Act? Should they not attempt to assay why we have a law of preferences?

The historical development of the law of preferences is nearly as complex as the present statute. With just a little digging, one finds Lord Mansfield at the bottom of the development of the preference idea. A general question has been started, "whether in any case, upon the eve of a bankruptcy, a man may do that which in consequence prefers a particular creditor:" and that has been argued as a general question.

But that will depend upon the act. As, if a bankrupt, in course

44 Other avoiding powers of the trustee do not answer this objection, because a violation of § 9-108 does not affect the perfection of the security interest, nor does such a violation constitute proof of a fraudulent conveyance. But see Comment, supra note 43, at 156-57.

of payment pays a creditor; this is a fair advantage, in the course of trade: or, if a creditor threatens legal diligence, and there is no collusion; or begins to sue a debtor; and lie makes an assignment of part of his goods; it is a fair transaction, and what a man might do without having any bankruptcy in view. . . . But it never entered into the mind of any Judge, to say "that a man, in contemplation of an act of bankruptcy, could sit down and dispose of all of his effects to the use of different creditors:" for, that would be a fraud upon the acts of bankruptcy. But if done in a course of trade, and not fraudulent, it may be supported.46

This is a remarkable idea: if the debtor acts in the course of trade and not fraudulently, he can dispose of his assets to different creditors. But the emphasis on the debtor's state of mind ultimately led the English courts into a morass of technical confusion.47 We can breathe easily perhaps when we reflect that, after a brief flirtation, our bankruptcy law rejected the "state of mind of the debtor" test.48 In our present law the debtor's balance sheet is determinative, and issues of moral culpability explicitly enter the scene only to serve the pragmatic purpose of saving a transferee who neither knew nor had reason to know of the debtor's insolvency.49

Yet, in our law, or rather in our courts, the idea persisted that the debtor must be at fault before the transfer can be avoided. In interpreting the Act of 1898, the Supreme Court, perhaps rebelling against the avoidance of innocently made transfers, continued to protect creditors who arranged for their security outside the four month period but who delayed taking the final steps to complete the deal until some time within the period.50 The legal mechanics of this revolt involved the idea that the final step, such as recording within the four month period, could be related back to the time the security arrangement was made.51 The notion of an "equitable lien" arising at the original arrangement ideally served the purpose, because it supported the conclusion that a property interest had been established in the secured creditor outside the period.52

46 Alderson v. Temple, 4 Burr. 2235, 2241 (1812 ed.) (emphasis in original), to be distinguished from 1776 ed. which has different printing and from 98 Eng. Rep. 165, 168 (K.B. 1768).


49 A contrary rule "might be widely regarded as an intolerable interference with legitimate business." J. MACLACHLAN, BANKRUPTCY § 267 (1955).

50 Glenn, supra note 48, at 540.

51 The most significant "relation back" cases include Humphrey v. Tatman, 198 U.S. 91 (1905), and Thompson v. Fairbanks, 196 U.S. 516 (1905).

52 The highpoint of the "equitable lien" was Sexton v. Kessler & Co., 225 U.S. 90
In reaction to the relation back and equitable lien doctrines, the Chandler Act adopted the specific “lien creditor” test, under which the transfer was deemed to have occurred when it became so far perfected that no bona-fide purchaser from the debtor and no creditor could thereafter have acquired any rights in the property so transferred superior to the rights of the transferee.

This killed the equitable lien argument, because ancient learning established that a bona fide purchaser for value could cut off an equitable lien. There were murmurs that the new test was a classic case of overkill, since various forms of legitimate financing, particularly accounts receivable transactions, were imperiled. Soothing interpretations appeared and quieted any legislative battles. But the quiet was shortlived. As hostilities fell upon the world in the early 1940’s, war also broke out in the courts; and trustees temporarily won a total victory in 3 Corn Exchange Bank v. Klauder.

After World War II the combatants moved to the legislatures, and this time the accounts finance ragers prevailed on all fronts. Where state law protected the assignment against subsequent assignees at some time outside the four month period, the Chandler Act test for timing the transfer was of no concern to the accounts financier. Hence, states were asked to adopt a notice-filing, bookmarking, or simple validating statute, making the transfer effective when made or when the required notoriety was given. The states complied so completely that by 1950 two commentators reported that only in Mississippi did the preference problem remain.

Fresh from that victory, the secured creditor bar moved on to Washington to eliminate other concerns. The bona fide purchaser test threatened to delay the time of actual transfers in inventory financing, because the Uniform Trust Receipts Act, the Uniform Conditional Sales Act, and the various factor’s lien acts carried provisions that pro-

53 McLaughlin, Aspects of the Chandler Bill To Amend the Bankruptcy Act, 4 U. Chi. L. Rev. 369 (1937).


56 At least one such opinion was given private circulation early in 1940. See McLaughlin, Defining a Preference in Bankruptcy, 60 Harv. L. Rev. 233, 246 (1946).

57 318 U.S. 454 (1943).

58 Conwill & Ellis, Much Ado About Nothing: The Real Effect of Amended 60(a) on Accounts Receivable Financing, 64 Harv. L. Rev. 62, 78 (1950).
ected the buyer in the ordinary course of business. In 1950 the Bankruptcy Act was amended to eliminate the bona fide purchaser test in personal property cases and to substitute the lien creditor standard. In order to foreclose revival of the doctrines of relation back and equitable liens, the amendments also precluded recognition of equitable liens "where available means of perfecting legal liens" had not been employed, and set a twenty-one day limit on state laws allowing relation back for a delayed recording.

Whatever the difficulties in interpreting the 1950 amendments—and they are many—Congress clearly was rejecting the policy foundation of the Klauder case that accounts receivable financing was somehow a dirty business. The Uniform Commercial Code confirmed that decision and added new force to the campaign against secret liens by requiring public filing for all types of accounts receivable financing.

The 1950 amendments of the Bankruptcy Act were assailed by those who saw section 60 as exclusively devoted to the egalitarian creed that the preference provisions should be used to promote equality of treatment among all creditors. It seems plain that the egalitarian view was rejected in the preference amendments. Inventory and accounts financing received federal legislative protection, when they could have been left subject to the preference attack under the prior bona-fide-purchaser test.

Additional areas of concern included (1) fear that § 60 would be read to defeat all security interests in states where recording is required before the security interest is good against any creditor or bona fide purchaser, since even unavoidable delay in recording would result in delay in the transfer to make it for an antecedent debt, and (2) concern that some creditors with a statutory priority might always defeat security interests, and thus the security would always be subject to attack as a preference. Countryman, The Secured Transactions Article of the Commercial Code and Section 60 of the Bankruptcy Act, 16 LAW & CONTEMP. PROB. 76, 83 (1951).


The opponents of reform to diminish the effect of § 60a were vigorous. Oglebay, Proposed Revision of Section 60a of the Bankruptcy Act: A Step Backward, 51 COM. L.J. 263 (1946). Moore & Tone, Proposed Bankruptcy Amendments: Improvements or Retrogression? 57 YALE L.J. 683 (1948).

At least these ordinary commercial practices were not left subject to the peril of a preference claim. The House report on the amendments commented:
The depth of the bankruptcy bar's concern for the general creditor is difficult to measure, since the Code demands public notice of the secured creditor's position in nearly all cases. Secrecy of the lien is simply not a real risk to the general creditor class. Also, under section 9-108, certain conditions protecting the general creditor must be met before the transfer of the after-acquired property is considered to be for new value. Section 9-108 marches in the same direction as section 60a to the extent that both statutes are designed to promote commercial morality. We can reject section 9-108 entirely only by completely adopting the egalitarian notion that the bankruptcy preference should deprive secured creditors of any position obtained in the four month period. The problem seems to demand a more subtle answer. Commercial financing is too important to our economic life to subject the lender to the perils of preference for such artificial reasons as presented by the Atoms and Molecules game. The conclusion is buttressed when one notes that merely more paper work would often cure the defect.

Section 9-108, after all, is hedged in considerably. First, the security cannot be taken as an afterthought. Whenever a debtor enters a security agreement to secure an old debt with after-acquired collateral, the security interest, when it arises, is not protected as being for new value. The secured creditor must make an advance, incur an obligation, release a perfected security interest, or otherwise give new value. To the extent that the secured party does not give new value, the section implies that subsequent acquisitions are transfers for an antecedent debt.

In addition, the section also requires an examination of the method

The resultant confusion has cast grave doubt upon the validity of normal business security, in all of the areas covered by trust receipts, factors liens, oil leases, cattle loans, airplane-equipment financing, chattel mortgages, assignments of accounts receivable, conditional sales agreements for resale, etc. Indeed, a bank officer, who appeared as one of the witnesses at the subcommittee hearing, testified that the situation had come to such a pass that his institution was compelled to regard all such types of transaction as unsecured loans, and to rule on them, as to the terms which his bank was willing to enter into them, accordingly.


From 1946 to 1966 both non-notification financing and old line factoring grew from a total $4.3 billion to nearly $25 billion. National Commercial Finance Conference, Inc., Annual Volume of Financing and Factoring of Commercial Receivables 1940-65 (unpublished; on file in the Cornell Law Library). If comparable figures were available from the banks, the growth rate would probably be even greater, because banks came to the field late.

This point raises doubts about the use of § 9-108 to validate the security interest in cash proceeds in the hands of the debtor during the four month period, when the security agreement originally secured old debt as well as future advances. See In re White, — F. Supp. — (S.D. Ohio 1967).
by which the debtor acquired rights in the collateral. Echoing Lord Mansfield, the primary test protects only transactions in which the debtor acquired rights in the collateral in the ordinary course of his business. Thus, manipulative conduct, such as a crash sale, that inordinately "feeds" the security interest is not protected. In this light, the Code does more for the general creditor than treat the collateral as a river or stream or adopt the "two point" tracing rule of Tit for Tat. Unusual fluctuations in the four month period will be subject to the scrutiny of the bankruptcy court in a more realistic fashion than under any of the games outlined previously. We may be uncomfortable with an approach that leaves so many fact questions, but the method can be an effective weapon to prevent overreaching by the secured creditor as well as zealous generosity by the debtor.

The rule can have a far-reaching effect outside of bankruptcy. Until a bankruptcy petition is filed, no one knows when the four month preference period commences. Thus, any security interest in collateral acquired by a debtor outside the ordinary course of his business must be suspect at the outset, simply because bankruptcy may follow within four months. This factor will encourage business morality. On the other hand, treating all after-acquired interests that arise within four months of bankruptcy as preferences would only serve to thwart a desirable method of financing.

If section 9-108 is allowed to stand as the test for determining whether a transfer is supported by an antecedent debt, some guidelines must be evolved for the "ordinary course" test. We might immediately think of the cases decided under the bulk transfer laws, which require a notice to protected creditors whenever the debtor makes a bulk transfer not in the ordinary course of his business. Since the antecedent debt rule and the bulk transfer rule use the same terminology, employing the terms interchangeably in each section is naturally attractive. Yet, even though both provisions may aim at the protection of general creditors, we are dealing with two different kinds of protection. A court might properly define "ordinary course of business" broadly

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67 As an alternative to the ordinary course requirement, § 9-108 offers protection to the secured creditor if the debtor's rights were acquired "under a contract of purchase made pursuant to the security agreement within a reasonable time after new value is given." This alternative should not be troublesome, since it is consistent with the grace period for filing in the Bankruptcy Act § 60a(7), 11 U.S.C. § 96(a)(7). It is also consistent with the protections generally extended to purchase-money financing. See Hogan, Financing the Acquisition of New Goods Under the Uniform Commercial Code, 3 B.C. IND. & COM. L. REV. 115, 120 n.18, 154-55 (1962), reprinted in 1 COOGAN, HOGAN & VAGTS, supra note 15, § 19.02 [1][x], at 1968 n.18, and § 19.06, at 2008-11.

68 UCC § 6-102(1).
for bulk sales purposes in order to avoid the harsh consequence of failure to comply with the notice requirements.69 On the other hand, section 9-108 does not involve the problem of making a prospective decision about what constitutes compliance with the statute. The decision is mainly retroactive in that the past conduct of a debtor is being characterized; fixed guidelines for future cases are not being set. It is no more necessary to follow the bulk transfer cases than to adopt the standard of buying in ordinary course in the buyer-protection sections of Articles 2, 7, or 9.70 We are dealing with a different problem, involving different interests, and we should seek an answer in light of our specific question.

If the section 9-108 ordinary-course-of-business test is permitted to control, the examination of the higher metaphysics of transfer will be exchanged for an intensive factual exploration of the method, manner, and terms of the debtor’s acquisition of rights in the collateral. Of course, this offers an invitation to preference litigation in every bankruptcy involving inventory and accounts financing. There is little doubt that the invitation will be accepted. The thought of adding to the burgeoning expenses of bankruptcy administration should make even a law professor pause.71 Is there a way to narrow the opportunity for endless factual disputes, while preserving the possibility of taking a hard look at the malodorous transaction?72

Borrowing from the Tit for Tat game, but without risking approval of the deliberate preference, we can give the secured creditor the benefit of a rebuttable presumption. If there is no net increase in the value of the collateral between the day prior to the four month period and the date of bankruptcy, then the debtor’s acquisition of rights will be presumed to be in the ordinary course of business.73 Con-

70 UCC §§ 2-403, 7-504, 9-307.
71 Of the 186,219 ordinary bankruptcy cases closed in fiscal year 1966, only 18,532 were classified as “asset” cases, in which there was some distribution to creditors over and above exemptions and costs of administration. Nationally, expenses of administration absorbed 24.8% of these assets. There were 20,260 “nominal asset” cases in which the assets were consumed in payment of the costs of administration. Of the remaining cases, 116,407 were simply “no asset” cases. ADMINISTRATIVE OFFICE OF THE UNITED STATES COURTS, TABLES OF BANKRUPTCY STATISTICS for period ending June 30, 1966, at 7-11.
72 Norris Darrell might have been referring to this kind of problem when he reportedly stated: “the technicians will say something is all right when viscerally it smells bad.” M. MAYER, THE LAWYERS 343 (1967).
73 It is relatively easy for the lawyer examining these transactions to mistake the book value of the accounts for their true value. As the borrower comes closer to insolvency, the true value of his accounts receivable may become less than their value on his books. In his anxiety to increase his cash flow, the worried debtor may be more ready to ship
versely, if there is a net increase in the value of the collateral between
the two crucial dates, the secured creditor will be required to show that
the acquisitions were in the ordinary course of the debtor's business.

Perhaps a specific example will help to clarify the notion. In *Portland
Newspaper* the trustee raises the preference issue by showing that
some accounts arose within the four month period and secured the loan
made outside the period. Rose City then seeks the protection of section
9-108 by showing (1) that some "new value" was given at the outset of
the secured relationship, and (2) that (in non-purchase-money situa-
tions) the debtor's rights in the accounts arising within the four month
period were obtained in the ordinary course of the debtor's business.

The second of these requirements can be met by using the sug-
gested presumption. If the lender shows that there was no net increase
in the value of the collateral between the day prior to the four month
zone and the date of bankruptcy, the debtor's acquisition of rights in
the accounts during the four month period is presumed to be in the
ordinary course. Nevertheless, the trustee can still come forward with
evidence that the value fluctuated drastically during the four month
period and that the changes were unusual when compared to compar-
able periods in the debtor's business life. At this point the secured
creditor might respond with proof that explains the fluctuations, *e.g.*, seasonal activity, expansion of the business, end-of-year sales.

Similarly, unless the secured creditor is able to show initially that
the value of the collateral was not greater on the latter of the two sig-
nificant dates, he will be forced into a factual battle concerning the
"ordinary course" of the debtor's acquisitions. When the case is de-
cided on such a factual basis, there are two guidelines for the fact-
finder. First, section 9-108 specifically calls for a determination in light
of the debtor's course of business, not some standard course of business
formulated in terms of the "reasonable man." Of course, the deter-
mination whether a transfer is within the protected class cannot be
turned over to the debtor entirely. Encouraging the deliberate pref-
ere should be avoided. To this extent an objective test must be
interposed. Is there any business reason to explain the increase in value
defective or substandard merchandise, to ignore the credit ratings of his buyers, or to
ship to poor credit risks. Furthermore, the obligors on the accounts may lose interest
in paying the obligation when bankruptcy intervenes, because there is no longer a con-
tinuing relation with a supplier. All these factors combine to make the appraisal of
the accounts most difficult. The difficulty is enhanced by the fact that the firm lending on
an accounts receivable basis is in a sense fundamentally the expert in appraising the
value, since such determinations are a regular part of its business.

74 See note 67 supra.
of the collateral? Is that reason independent of the fact that the debtor's acquisition of rights will enhance the position of the lender?

A second guideline for the fact-finder may be found in the general obligation of good faith that runs throughout the Code. Section 1-203 incorporates the duty of subjective honesty in fact into every contract or obligation under the Act. If the trustee presents evidence showing that the debtor-bankrupt specifically intended to prefer the secured creditor at the time rights in the collateral were acquired, that evidence itself might tend to show that the transaction was not in the ordinary course of the debtor's business. In addition, evidence of a purposive preference may show a lack of subjective good faith. This second guideline is not particularly appropriate, however, because section 9-108 does not involve a contractual or statutory duty of the debtor and because the lack of good faith relates to a Bankruptcy duty, not to a Code obligation. Despite these technical distinctions, the good faith test may by analogy supply help in defining "ordinary course."

The presumption of an "ordinary course" acquisition is particularly helpful because it protects an arrangement made well outside of the four month zone. That some of the collateral is acquired within the four month period does not adequately support an attack on a non-fraudulent and filed secured transaction entered into a year before bankruptcy. On the other hand, the presumption will not safeguard in any way the secured creditor who enters into an arrangement with the debtor entirely within the four month period. Such a creditor will be forced to establish that the acquisition of the debtor's rights was in the ordinary course of his business. The same demand will be placed on the secured creditor who claims as after-acquired property collateral acquired in the four month period when he had no collateral.

**Conclusion**

Even a fleeting glance at the recent history of the law of preferences raises doubts about the effectiveness of statutory repairs to the preference rules of the Bankruptcy Act as the means of recognizing commercially accepted forms of financing. The acceptance of the Uniform Commercial Code by forty-nine states and by Congress for the District of Columbia strongly suggests that section 9-108 does not license conduct that the country regards as immoral or commercially unacceptable. On the contrary, even in those states where the Code was scrupulously scrutinized, section 9-108 was left untouched. A sensitive

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75 Only Alaska modified § 9-108, and then only to alter its language rather than its substance. I CCH INSTALMENT CREDIT GUIDE ¶ 708 (1967).
and sensible recognition of the Code rule will permit us to concentrate on the facts of the particular problem and to leave behind the fun-filled, but unreal games we have been playing with inventory and accounts receivable financing.