ON PROOF OF PREFERENTIAL EFFECT

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ABSTRACT

In this Article, Professor Rafael Pardo presents a comprehensive analysis of the manner in which the trustee of a debtor's estate may satisfy his burden of proof to demonstrate the preferential effect of a prebankruptcy transfer from a debtor to a creditor. The proposed framework, if adhered to by courts, will create a uniformity that gives preference law its proper reach and thereby reinforces its primary goal: equal treatment of similarly situated creditors (the "equality principle"). After examining the historical developments that have made a trustee's evidentiary burden administratively less complex, Professor Pardo discusses the Ninth Circuit's decision in *Batlan v. TransAmerica Commercial Finance Corp. (In re Smith's Home Furnishings, Inc.)* to illustrate how a court impairs the "avoidance" of preferential transfers when it creates a rule that improperly construes a trustee's evidentiary burden. He rejects the court's rule on the basis that it neither comports with the Bankruptcy Code's test for preferential effect nor with the evolution of the trustee's burden of proof. He concludes that, although the ultimate burden of proof rests on the trustee as he presents his prima facie case for preference avoidance, courts must give effect to state law presumptions in favor of the trustee. Failure to do so gives certain creditors procedural advantages, and possibly substantive advantages, to which they would otherwise not be entitled, thus compromising the equality principle.

INTRODUCTION

Bankruptcy is the process whereby a debtor's estate is collectively administrated such that distributions to creditors of the debtor proceed according to the statutory provisions set forth in the Bankruptcy Code (the "Code").[1] This process contrasts starkly with the pursuit of individual reme-

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1. *See* THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW 20 (1986) ("Bankruptcy provides a collective forum for sorting out the rights of . . . creditors and others with rights against a debtor's assets . . . . This makes the basic process one of determining who gets what, in what order." (emphasis omitted)); Andrew DeNatale & Prudence B. Abram, *The Doctrine of Equitable Subordination As Applied to Nonmanagement Creditors*, 40 BUS. LAW. 417, 418 (1985) ("Generally, all the substantive

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dies by creditors outside of bankruptcy where the distributive principle that generally governs is "first in time, first in right:" A creditor must be the first to take the necessary steps to establish legal entitlement to satisfaction of the debt owed to it from a particular asset of the debtor in order to be given priority over subsequent creditors who make claim to the same asset.[2] The commencement of a bankruptcy case immediately effectuates the shift from a regime of individual debt collection to a compulsory and collective proceeding.[3] Once this shift has occurred, hindsight calls into question certain prebankruptcy transfers of the debtor to its creditors.[4]

When a debtor makes a transfer of property or interest therein to a creditor before bankruptcy, the concern arises not that the creditor receives prior to other creditors, but rather that the transfer renders the creditor better off than others with similar legal entitlements. A prebankruptcy transfer will be "preferential," generally speaking, if it allows a creditor to receive more than he otherwise would have received absent the transfer.[5] That transfer disturbs the ordered arrangement for dispensing the proper distributive shares from assets of a debtor's estate. If the Code is to be applied equally to similarly situated creditors, "preferential transfers" must be defeated.[6]

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provisions of bankruptcy law relate to either the marshalling or distribution functions."). This Article uses the term "Code" to refer to the Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 (1978) (codified as amended primarily at 11 U.S.C. §§ 101-1330 (2000)).

2. *See* JACKSON, *supra* note 1, at 8-9 ("Creditor remedies outside of bankruptcy . . . can be accurately described as a species of 'grab law,' represented by the key characteristic of first-come, first-served. The creditor first staking a claim to particular assets of the debtor generally is entitled to be paid first out of those assets."). There are of course exceptions to this rule. The status of Creditor A as an individual that falls within a protected class, for example, may entitle it to priority over Creditor B, notwithstanding that Creditor B was first in time. *See, e.g.*, 735 ILL. COMP. STAT. 5/12-808(c) (2003) (granting priority to garnishment lien relating to support of spouse or dependent child—regardless of when lien arose—over other garnishment liens).

3. The filing of a bankruptcy petition efficiently achieves this result by: (1) creating an estate that includes all of the debtor's legal and equitable interests in property that exist as of the petition date, 11 U.S.C. § 541(a)(1); (2) staying the pursuit of individual remedies by creditors against the debtor and property of its estate, *see id.* § 362(a); and (3) triggering the exclusive jurisdiction of the bankruptcy court, through referral from the district court, *see* 28 U.S.C. § 157(a) (2000), over the debtor's case and property of its estate, *see id.* § 1334(a), (e). *See* Rafael Ignacio Pardo, Comment, *Bankruptcy Court Jurisdiction and Agency Action: Resolving the* NextWave *of Conflict*, 76 N.Y.U. L. REV. 945, 948 (2001) ("The convergence of a bankruptcy court's jurisdictional grant and the automatic stay therefore enables the court to conduct a uniform proceeding in a single forum where the court may adjudicate all claims related to the bankrupt estate." (footnote omitted)). *See* JACKSON, *supra* note 1, at 7-19, for a comprehensive discussion on the nature of bankruptcy as a "collectivized debt-collection system."

4. *See* John C. McCoid II, *Bankruptcy, Preferences, and Efficiency: An Expression of Doubt*, 67 VA. L. REV. 249, 260 (1981) ("Although preference law comes into play only after bankruptcy proceedings have been instituted, its focus is on the period between the onset of insolvency and bankruptcy, and its target is a transfer to one creditor during that period.").

5. *See infra* note 28 and accompanying text.

6. *See* Robert Charles Clark, *The Duties of the Corporate Debtor to Its Creditors*, 90 HARV. L. REV. 505, 512 (1977) ("[T]ransfers resulting in better than equal treatment on the eve of liquidation proceedings should be undone—and may actually be undone in bankruptcy proceedings as voidable preferential transfers."); Lawrence Ponoroff, *Evil Intentions and an Irresolute Endorsement for Scientific Rationalism: Bankruptcy Preferences One More Time*, 1993 WIS. L. REV. 1439, 1446-47 (1993) ("Because of its emphasis on collectivizing the debt collection function, bankruptcy cannot tolerate asset transfers made in contemplation of liquidation and that favor one creditor at the expense of other creditors of the same class."); Charles Seligson, *The Code and the Bankruptcy Act: Three Views on Preferences and After-Acquired Property*, 42 N.Y.U. L. REV. 292, 292 (1967) ("A cornerstone of the bank-

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The Code provides that the trustee of a debtor's estate may "avoid" and thereby recover a preferential transfer.[7] Avoidance and recovery work in tandem to ensure that the Code's priority ladder for distribution remains intact by restoring the parties to their pretransfer positions: The estate's assets are increased for the benefit of all creditors;[8] the preferred creditor is granted the same legal rights it had before the transfer;[9] and distribution on account of creditor claims proceeds pursuant to the Code.[10]

The principle of equal treatment of similarly situated creditors (the "equality principle") underlies the trustee's preference-avoiding powers.[11] Although Congress identified deterrence and the equality principle as the two purposes behind the Code's preference provision,[12] it is more appropriate to view the latter as the primary justification for preference law.[13] An

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ruptcy structure is the principle that equal treatment for those similarly situated must be achieved. It would be highly inequitable to disregard what transpires prior to the filing of the bankruptcy petition . . . ."); *cf.* Vern Countryman, *The Concept of a Voidable Preference in Bankruptcy*, 38 VAND. L. REV. 713, 715 (1985) ("Only when the legal system provides, as an alternative to the creditors' unilateral grab-law system, a procedure for collective administration of the debtor's estate with a prescribed order of distribution to all creditors, can we expect the lawmakers to become concerned about the debtor's preadministration transfers that will frustrate the prescribed order of distribution.").

7. *See* 11 U.S.C. § 547(b) (permitting trustee to avoid preferential transfer); *id.* § 550(a) (providing that, to the extent transfer is avoided, a trustee may recover property transferred (or the value thereof if the court so orders)).

8. *See id.* § 541(a)(3) (providing that transfers the trustee recovers under avoiding powers constitute property of the estate).

9. *See id.* § 502(h) (stating that claim of creditor arising from the recovery of property by a trustee is to be determined as if it were a prepetition claim).

10. *See, e.g., id.* § 726(a) (establishing the order of distribution of property of an estate in a Chapter 7 case).

11. *See* H.R. REP. NO. 95-595, at 177-78 (1977) ("[T]he 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."), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6138; DeNatale & Abram, *supra* note 1, at 418 ("The substantive laws of bankruptcy have developed over the years to expand and codify certain concepts of fairness and equality among creditors. The concepts include the trustee's arsenal of avoiding powers related to fraudulent conveyances and preferences. Although the concepts take on different labels and criteria, the intended result is the same, to wit, equality of distribution."). While the legislative history of § 547 refers to the "prime bankruptcy policy of equality of distribution," *see* H.R. REP. NO. 95-595, at 178, *reprinted in* 1978 U.S.C.C.A.N. 5963, 6138, it is more accurate to refer to that policy as "equal treatment of similarly situated creditors" since the distribution provisions of the Code are aimed at maintaining equality within distinct classes of creditors. *See* Countryman, *supra* note 6, at 748 ("Statements in the legislative history also mention preserving the bankruptcy policy of 'equality' of distribution. But, with creditors classified for distribution purposes on the basis of liens and priorities, no bankruptcy policy of 'equality' exists. A policy of preserving classes and of preserving equality within classes does exist, however, and the preference concept is designed to preserve this policy." (footnotes omitted)).

12. *See* H.R. REP. NO. 95-595, at 177-78, *reprinted in* 1978 U.S.C.C.A.N. 5963, 6138; *see also* Danning v. Bozek (*In re* Bullion Reserve of N. Am.), 836 F.2d 1214, 1217 (9th Cir. 1988) ("The dual purpose of § 547 . . . is to discourage creditors from racing to the courthouse to dismember the debtor during its slide into bankruptcy and to further the prime bankruptcy policy of equal distribution among similarly situated creditors.").

13. Countryman, *supra* note 6, at 824 (stating that the purpose of preference law is to "preserve the bankruptcy distribution policy"); Ponoroff, *supra* note 6, at 1479 (arguing that, in light of the Code's elimination of *mens rea* standards in defining preferential transfer, "the effect of the change has been to elevate equality of distribution to the dominant policy aim of preference law"); Charles Jordan Tabb, *Rethinking Preferences*, 43 S.C. L. REV. 981, 986-95 (1992); *see* David Gray Carlson, *Security Interests in the Crucible of Voidable Preference Law*, 1995 U. ILL. L. REV. 211, 215-19 (setting forth arguments why deterrence may not be the principal purpose of preference law); McCoid, *supra* note 4, at 263-64

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analysis regarding the Code's preference provision or its application should therefore ask whether the equality principle has been compromised.[14]

This Article concerns itself with the manner in which a trustee must establish the preferential effect of a transfer that is subject to avoidance. Proof of preferential effect merits close consideration since it is dispositive as to whether a trustee succeeds in a preference avoidance action. Failure by the trustee to satisfy his burden of proof is obviously not troublesome where the evidence will not substantiate a claim of preference. On the other hand, where the evidence would support a finding of preferential effect but for an improper judicial interpretation of the evidentiary pleading required by a trustee, a court has failed to give preference law its proper effect and has simultaneously undermined the equality principle.

We might assume that, twenty-five years after the Code was enacted,[15] an understanding of proof of preferential effect would be well settled. The Ninth Circuit's decision in *Batlan v. TransAmerica Commercial Finance Corp. (In re Smith's Home Furnishings, Inc.)*[16] suggests otherwise. In that case, the court needlessly departed from the test established by the Code for preferential effect (the "greater amount test") and improperly concluded that a series of transfers were not preferential by failing to give effect to a state law presumption in favor of the trustee. The case offers an opportunity to revisit the concept of proof of preferential effect and to establish a manner in which it can be proffered consistent with the equality principle.

Part I of this Article considers the greater amount test and reduces it to a formalized set of rules that, as illustrated by the mathematical proofs appearing in the Appendix, confirm the exact conditions that inevitably yield a preferential transfer. Keeping in mind that the preference provision of the Code "represents a novel attempt to accomplish the multiple goals of the preference law in an expeditious, cost-effective manner,"[17] the possibility of overenforcement as well as underenforcement threatens to undermine its correct application and thereby yield unwanted and unnecessary costs. A precise accounting of what constitutes preferential effect and the certainty that stems therefrom will help prevent such undesirable outcomes.

(questioning whether preference law has a deterrent effect). *Contra* JACKSON, *supra* note 1, at 125 ("[P]reference law exists to prevent creditors from trying to change their existing position vis-à-vis other creditors in anticipation of bankruptcy's collective proceeding . . . ."). Regardless of whether the dominant theme is the equality principle or deterrence, preference law ultimately embodies both concepts and can be viewed as one of the stabilizing forces intended to preserve the "scheme of social cooperation" envisioned by the Code. *Cf.* JOHN RAWLS, A THEORY OF JUSTICE 6 (1971) ("[T]he scheme of social cooperation must be stable: it must be more or less regularly complied with and its basic rules willingly acted upon; and when infractions occur, stabilizing forces should exist that prevent further violations and tend to restore the arrangement.").

14. *See* DeNatale & Abram, *supra* note 1, at 418 ("In order to determine whether a certain result is fair or just, one must be mindful of the broad purposes for which bankruptcy laws exist, to wit, the marshalling of assets . . . . Although the orchestral functions are marshalling and distribution, the contrapuntal theme is intended to be equality of distribution.").

15. The Code was enacted in 1978. *See supra* note 1.

16. 265 F.3d 959 (9th Cir. 2001).

17. Ponoroff, *supra* note 6, at 1520.

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Part II of this Article first examines the general evolution of the trustee's evidentiary burden regarding proof of preferential effect. Observing that the burden has become less stringent over time, the Article then proceeds to focus on the specific change in preference law that has facilitated the trustee's preference attack vis-à-vis a floating lien creditor. The Article then considers the holding in *In re Smith's Home Furnishings, Inc.* as an example of judicial misapplication of the greater amount test as applied in the floating lien context. It rejects the evidentiary rule established by the court on the grounds that it contravenes the test and that the historical record does not justify such a departure. Part II concludes with consideration of an ancillary issue raised in the Ninth Circuit's decision that profoundly impacts application of the Article's model for preferential effect: whether the trustee, in establishing his prima facie case for avoidance of a preferential transfer, can avail himself of a state law presumption directed at the creditor who received the transfer. The Article contends that such a practice is consistent with the burden of proof imposed on the trustee by the Code and urges that failure to give effect to such a presumption will result in unequal procedural treatment of similarly situated creditors, thus undermining the equality principle.

I. THE PREFERENTIAL EFFECT OF A TRANSFER

This Part establishes the circumstances under which a prebankruptcy transfer will give rise to preferential effect and expresses them as concrete rules with the goal of creating a uniform standard for classifying such transfers as preferences. Part I.A considers the economic benefit to a creditor that the Code defines as having a preferential effect. Part I.B delineates, by reference to the secured status of the transferee-creditor's claim on the date of bankruptcy, the different permutations regarding the transfer of liens and payments prior to bankruptcy that yield a preference. Those permutations are the basis for this Article's framework for preferential effect analysis. Part I.C sets forth the arguments that justify and compel adherence by trustees and courts to the framework—namely, preventing overenforcement and underenforcement of the trustee's power to avoid preferential transfers.

A. *The Definition of Preferential Effect*

Section 547 of the Code requires that five elements be met for a transfer to constitute a voidable preference.[18] The transfer must be made (1) to or for the benefit of a creditor,[19] (2) on account of an antecedent debt,[20] (3) while the debtor is insolvent,[21] (4) within ninety days before bankruptcy (for non-

18. 11 U.S.C. § 547(b) (2000).
19. *Id.* § 547(b)(1).
20. *Id.* § 547(b)(2).
21. *Id.* § 547(b)(3).

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insiders);[22] and (5) the transfer must enable the creditor to receive a greater amount had the transfer not occurred and had the creditor received payment in a hypothetical Chapter 7 liquidation.[23] It allocates the burden of proof between the trustee and the transferee in the following manner: The trustee has the burden to establish the avoidability of a transfer and the burden of pleading, proof, and persuasion with respect to all five elements of a preference.[24] Once the trustee has established all the elements of a preference, the burden shifts to the transferee to establish one of the statutory defenses provided by the Code.[25]

As previously discussed, to further the equality principle, the Code targets what is deemed to be an improper economic benefit received by a creditor.[26] The fifth element of the preference section defines that benefit, whereas the other four elements specify the circumstances under which the benefit must occur.[27] A transfer is deemed preferential when a creditor enjoys a greater recovery on its claim than it would have if the transfer had not occurred and if recovery proceeded according to the order of distribution in a Chapter 7 case.[28] Courts sometimes refer to this inquiry as the "greater amount test."[29] In the absence of the improper economic benefit of greater recovery, distribution on account of the transferee's claim prior to bankruptcy is irrelevant since the transferee would have ultimately received the same amount had the transfer not occurred.[30]

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22. *Id.* § 547(b)(4).
23. *Id.* § 547(b)(5).
24. Batlan v. TransAmerica Commercial Fin. Corp. (*In re* Smith's Home Furnishings, Inc.), 265 F.3d 959, 963 (9th Cir. 2001) ("Section 547(g) places the burden of proof on the trustee to show all of the conditions of § 547(b)."); Lowery v. Manufacturer's Hanover Leasing Corp. (*In re* Robinson Bros. Drilling, Inc.), 6 F.3d 701, 703 (10th Cir. 1993); Waldschmidt v. Ranier (*In re* Fulghum Constr. Corp.), 706 F.2d 171, 172 (6th Cir. 1983) ("As is facially evident from this provision, all five enumerated criteria must be satisfied before a trustee may avoid any transfer of property as a preference."); *see* 11 U.S.C. § 547(g) ("For the purposes of this section, the trustee has the burden of proving the avoidability of a transfer under subsection (b) of this section . . . ."). The Code, however, creates a rebuttable presumption with respect to the debtor's insolvency during the preference period. *See id.* § 547(f) ("For the purposes of this section, the debtor is presumed to have been insolvent on and during the 90 days immediately preceding the date of the filing of the petition."). By virtue thereof, the trustee generally is relieved from presenting evidence with respect to the debtor's insolvency. *See infra* notes 106-07 and accompanying text.
25. 11 U.S.C. § 547(g); Krafsur v. Scurlock Permian Corp. (*In re* El Paso Refinery, L.P.), 171 F.3d 249, 253 (5th Cir. 1999). Section 547(c) of the Code sets forth the statutory defenses available to a transferee-defendant in a preference action. 11 U.S.C. § 547(c).
26. *See supra* notes 5-14 and accompanying text.
27. *See* 11 U.S.C. § 547(b).
28. *Id.* § 547(b)(5). Subsection (b)(5) provides that preferential effect results from a transfer "that enables such creditor to receive more than such creditor would receive if— (A) the case were a case under chapter 7 of [the Code]; (B) the transfer had not been made; and (C) such creditor received payment of such debt to the extent provided by the provisions of [the Code]." *Id.* 11 U.S.C. § 726(a) sets forth the order of distribution of property of the estate in Chapter 7 cases.
29. *E.g.*, *In re Smith's Home Furnishings, Inc.*, 265 F.3d at 963; Alvarado v. Walsh (*In re* LCO Enters.), 12 F.3d 938, 940 (9th Cir. 1993); Elliot v. Frontier Prop. (*In re* Lewis W. Shurtleff, Inc.), 778 F.2d 1416, 1422 (9th Cir. 1985); Estate of Love v. First Interstate Bank (*In re* Love), 155 B.R. 225, 232 (Bankr. D. Mont. 1993); *see also* Ponoroff, *supra* note 6, at 1504 n.191 (referring to inquiry under 11 U.S.C. § 547(b)(5) as greater amount test).
30. *See, e.g.*, *infra* text accompanying notes 62-64.

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While the Code does not establish a point in time for determining whether a transfer resulted in a preference, the prevailing view is that Congress codified the rule established by the Supreme Court in *Palmer Clay Products Co. v. Brown*[31] when it enacted the Code's preference provision.[32] The Court there held that preferential effect is to be determined as of the date of bankruptcy (the "petition date"), and not on the date of the transfer.[33] Explaining the rationale for the rule, the Court reasoned that, if it construed the preference provision of the Bankruptcy Act of 1898 (the "Bankruptcy Act") [34] to require proof of preferential effect at the time of transfer, the trustee would be confronted with an impractical evidentiary burden, which would lead to inefficient results and frustrate the Bankruptcy Act's statutory scheme.[35] While some have argued that the date of transfer should be the date of the hypothetical liquidation under the greater amount test,[36] this Article proceeds in accordance with the prevailing view that the petition date is the proper one for determining whether a transfer has preferential effect.

31. 297 U.S. 227 (1936).

32. 5 COLLIER ON BANKRUPTCY ¶ 547.03[8], at 547-46 (Lawrence P. King ed., 15th ed. rev. 2002) (noting that § 547(b)(5) "codifies the Supreme Court's holding in *Palmer Clay Products Co. v. Brown* . . . ."); *see* Neuger v. United States (*In re* Tenna Corp.), 801 F.2d 819, 823 (6th Cir. 1986) ("Congress is presumed to have been aware of the Supreme Court's interpretation of the prior preference provision [in *Palmer Clay Products Co.*]. The changes in the new provision from the prior one are not so great that we can not apply that presumption here." (citation omitted)); *see also* Countryman, *supra* note 6, at 735-36 ("[M]ost courts have had no difficulty in reading section 547(b)(5) as incorporating the rule of *Palmer Clay Products* . . . .").

33. *Palmer Clay Prods. Co.*, 297 U.S. at 229 ("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 payment as determined when bankruptcy results."). This includes valuation of the collateral. *See In re Smith's Home Furnishings, Inc.*, 265 F.3d at 971 (Graber, J., dissenting) ("[T]he relevant date for assessing the value of the collateral securing a creditor's debt is the petition date . . . ."); Dakmak v. United States (*In re* Lutz), 241 B.R. 172, 177 (E.D. Mich. 1998) (observing that, for purposes of the greater amount test, a creditor's claim is to be considered on the petition date); Carlson, *supra* note 13, at 265 (noting that collateral "must be valued as of the day of the bankruptcy petition, if only for the narrow purpose of conducting the hypothetical liquidation test"); Countryman, *supra* note 6, at 740-41 ("The logic of *Palmer Clay Products* and of section 547(b)—both of which search for the effect of the transfer on what otherwise would have been a Chapter 7 distribution—indicates that the valuation of the collateral should be made at the time of the Chapter 7 distribution." (footnote omitted)). *But see* Travelers Ins. Co. v. Cambridge Meridian Group, Inc. (*In re* Erin Food Servs., Inc.), 980 F.2d 792, 801 n.15 (1st Cir. 1992); Telesphere Liquidating Trust v. Galesi (*In re* Telesphere Communications, Inc.), 229 B.R. 173, 180 (Bankr. N.D. Ill. 1999) (noting that, for purposes of the greater amount test, collateral is to be valued as of the date of transfer); *see also* Abramson v. St. Regis Paper Co. (*In re* Abramson), 715 F.2d 934, 939 n.9 (5th Cir. 1983) (stating that, under the preference provision of the Bankruptcy Act, valuation is to be determined as of the time of transfer, not as of the date of bankruptcy filing).

34. Act of July 1, 1898, ch. 541, 30 Stat. 544 (repealed 1978).

35. *See Palmer Clay Prods. Co.*, 297 U.S. at 229 ("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?"); *see also* JACKSON, *supra* note 1, at 127 n.10 (noting that "valuations—even market valuations—at the date of the transfer may be difficult to ascertain after the fact").

36. JACKSON, *supra* note 1, at 126-27 n.10 ("[T]he policies underlying the preference section suggest that the relevant comparison should be made using expected values as of the date of the transfer. . . . This suggests that the resolution in *Palmer Clay Products v. Brown* is, as a normative matter, wrong." (citation omitted)); James J. White & Daniel Israel, *Preference Conundrums*, 98 COMM. L.J. 1, 11-15 (1993).

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B. *Proof of Preferential Effect*

Seemingly, application of the greater amount test should be mechanical and straightforward in nature. But to apply it properly, a thorough understanding of the manner in which a trustee satisfies his burden of proof is essential. The greater amount test has been criticized on the basis that results obtained through its correct application often conflict with intuitions of what properly constitutes a preferential transfer.[37] I do not attempt, however, to reconcile such a disconnect. Rather, by creating a coherent view of proof of preferential effect, I ultimately seek to facilitate discourse that focuses on how preference law can be amended to serve the equality principle more effectively.[38] I propose the following conceptual framework, based upon the mathematical proofs set forth in the Appendix.

1. *The Analytical Framework*

The focal point of the greater amount test is the hypothetical result that would have occurred if "the transfer had not been made."[39] That language stands for the proposition that the trustee is required to calculate the difference between the actual result and the hypothetical result.[40] A transfer has preferential effect where the former exceeds the latter—that is, the transfer "enables [the] creditor to receive more"[41] than it otherwise would have absent the transfer.

Thus, to calculate preferential effect, analysis starts with noting three numbers: (1) the amount owed to the transferee on the petition date, (2) the amount of collateral, if any, that secures the amount owed, and (3) the amount of the transfer made to the creditor during the preference period.[42]

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37. *See* Carlson, *supra* note 13, at 256-79.

38. By no means do I suggest that the analytical framework for preferential effect proposed in this Article signifies an end to the inquiry into what properly constitutes a preference. With certainty and efficiency as goals in mind, I merely seek to express via definite rules the type of economic benefit that constitutes preferential effect as currently defined by the Code. For the argument that bright-line rules better serve preference law and the equality principle, *see* Ponoroff, *supra* note 6, at 1439-52, 1482 n.121.

39. 11 U.S.C. § 547(b)(5)(B) (2000).

40. *See* Batlan v. TransAmerica Commercial Fin. Corp. (*In re* Smith's Home Furnishings, Inc.), 265 F.3d 959, 970 (9th Cir. 2001) (Graber, J., dissenting) (observing that "11 U.S.C. § 547(b)(5) directs a court that is analyzing a preference claim to compare two quantities: the amount that the creditor actually received, and the amount that the creditor would have received in a hypothetical chapter 7 liquidation had the allegedly preferential transfers not been made"); 5 COLLIER ON BANKRUPTCY, *supra* note 32, ¶ 547.03[7], at 547-39 (noting that 11 U.S.C. § 547(b)(5) "requires a comparison between what the creditor actually received and what it would have received under the chapter 7 distribution provisions of the Code").

41. 11 U.S.C. § 547(b)(5).

42. Although I refer to "amount" in the singular, note that multiple transfers will yield multiple "amounts." Accordingly, when the oversecured status of a creditor's claim results from a series of prepetition transfers, none of which would be preferential if considered individually, the transfers will have to be considered in the aggregate. 1 U.S.C. § 1 provides that "[i]n determining the meaning of any Act of Congress, unless the context indicates otherwise[,] words importing the singular include and apply to several persons, parties, or things . . . ." 1 U.S.C. § 1 (2000). This directive makes clear that use of the singular does not exclude use of the plural. Thus, although the language of § 547(b) refers to an individ-

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The amount owed and the amount of collateral are complementary amounts in the sense that they establish the secured status of a claim when considered in relation to one another. As set forth below, the extent to which a creditor's claim is secured on the petition date is a critical factor in determining the preferential effect of a transfer.[43] Accordingly, it is particularly relevant to look at how the Code resolves whether a claim is secured.

The Code limits the amount of a secured claim to the value of the collateral (1) that is subject to the creditor's lien and (2) in which the debtor's estate has an interest.[44] Put another way, an allowed secured claim is equal to the lesser of the debt owed to the creditor or the value of the collateral. To the extent the amount of debt exceeds the value of the collateral (i.e., to the extent a "collateral deficiency" exists), the creditor has an unsecured claim in that amount.[45] This limitation has the effect of bifurcating a claim that is undersecured into both a secured and unsecured claim.[46] A prebankruptcy transfer, in turn, can affect the bifurcation of the claim of the creditor who received the transfer. Consider, for example, the transfer of a security interest to a creditor with an undersecured claim. The transfer will increase the creditor's secured claim with a corresponding decrease in the unsecured claim. Similarly, consider the payment to a creditor with an undersecured claim. The payment will reduce the amount owed to the creditor and correspondingly decrease the creditor's unsecured claim and increase its secured claim. The greater amount test must account for these fluctuations.

A prebankruptcy transfer can take one of two forms: It can be (1) a security transfer (e.g., consensual lien, judicial lien, statutory lien) or (2) an absolute transfer (e.g., payment). Depending on the type of transfer, either the amount of collateral or the amount owed will be adjusted in calculating the hypothetical amount that is the focus of the greater amount test. If a security transfer is the subject of the trustee's analysis, the amount of the collateral securing the debt owed to the transferee will be reduced to calculate the hypothetical result absent the transfer.[47] If, on the other hand, an absolute transfer is at issue, the amount of the debt owed to the transferee will be

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ual transfer, an aggregated analysis of multiple transfers during the preference period is appropriate. *But see* Carlson, *supra* note 13, at 262-63 (questioning whether aggregated analysis can be properly justified since it takes into account postpetition events and since the hypothetical liquidation test is confined to the petition date).

43. *See infra* Tables 1, 2.

44. *See* 11 U.S.C. § 506(a) ("An allowed claim of a creditor secured by a lien on property in which the estate has an interest . . . is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property . . . .").

45. *See id.* ("An allowed claim of a creditor secured by a lien on property in which the estate has an interest . . . is an unsecured claim to the extent that the value of such creditor's interest . . . is less than the amount of such allowed claim.").

46. *See* Barash v. Pub. Fin. Corp., 658 F.2d 504, 507 (7th Cir. 1981) (noting that § 506 "separates undersecured creditors' claims into two parts: a secured component and an unsecured component"); S. REP. NO. 95-989, at 68 (1978) (noting that § 506(a) "separates an undersecured creditor's claim into two parts: He has a secured claim to the extent of the value of his collateral; and he has an unsecured claim for the balance of his claim."), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5854; H.R. REP. NO. 95-595, at 356 (1977) (same), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6312.

47. *See infra* Part I.B.2.

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increased to calculate the hypothetical result absent the transfer.[48] Thus, the initial point of departure for analyzing preferential effect is to *identify the type of transfer in question.*

Next, the focus shifts to identify the class of claims to which the transferee's claim belongs and determining the percent distribution that would have been made on account of the claims within the class if the transfer had not occurred.[49] When funds in a Chapter 7 case are insufficient to satisfy in full the claims of a particular class, distribution on each claim within the class is made on a pro rata basis.[50] In such an instance, the dividend on each claim will be less than 100%.[51] This is particularly relevant when: (1) a security transfer has the effect of (a) converting a claim from unsecured to undersecured or fully secured, (b) reducing the collateral deficiency of an undersecured claim, or (c) converting an undersecured claim to a fully secured or oversecured claim; or (2) an absolute transfer has the effect of reducing the amount of the unsecured portion of the creditor's claim. The following sections will discuss each of these situations in the context of both security transfers and absolute transfers.

2. *Security Transfers*

Recall that the Code informs us that a creditor has a secured claim to the extent of the value of the collateral securing the claim.[52] The concern that arises with a prebankruptcy security transfer is that it potentially reduces the amount of a transferee's unsecured claim. To show the effect of a security transfer never having occurred, one merely subtracts the amount of the security transfer from the value of any collateral that secures the creditor's underlying claim and then proceeds with an analysis to determine the secured status of the claim (i.e., unsecured, undersecured, fully secured, or oversecured).[53] If, on the petition date, the transferee has an allowed claim that is oversecured by at least the amount of the transfer,[54] then the trans-

48. *See infra* Part I.B.3.

49. 5 COLLIER ON BANKRUPTCY, *supra* note 32, ¶ 547.03[7], at 547-44 ("In making its determination, the court must decide the transferee's class and determine what distribution that class would have received had the transfer not been made."); *see also* Gertz v. BancOhio Nat'l Bank (*In re* Conn), 9 B.R. 431, 433-34 (Bankr. N.D. Ohio 1981) ("The Court must also consider the classes of creditors as provided for under Sections 507 and 506 [of the Bankruptcy Code]."); S. REP. NO. 95-989, at 87 ("[T]he court must focus on the . . . amount that will be received by the members of the class of which the [creditor] is a member."), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5873; H.R. REP. 95-595, at 372 (same), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6328; *cf.* Raymond T. Nimmer, *Security Interests in Bankruptcy: An Overview of Section 547 of the Code*, 17 HOUS. L. REV. 289, 294 (1980) ("The benefits of the alleged preference are measured apart from the earlier value given, but in juxtaposition to the status of other creditors who occupied similar situations and did not receive a similar transfer.").

50. 11 U.S.C. § 726(b) (2000).

51. For example, if only $50,000 remains for distribution from the debtor's estate and the claims within the class collectively amount to $100,000, each creditor within the class will receive a 50% dividend on its claim.

52. *See supra* note 44 and accompanying text.

53. *See infra* Appendix, Part A.

54. That is, the amount owed is less than or equal to the value of the collateral less the amount of the

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feree will not have received a greater amount by virtue of the security transfer. Under such conditions, subtracting the amount of the security transfer from the value of the collateral will never result in the underlying claim exceeding the value of the collateral.[55] Had the security transfer not taken place, the transferee would nonetheless have had a fully secured claim on the petition date and would have been entitled to payment in full.[56]

If on the petition date, however, the transferee has an allowed claim that is not oversecured by at least the amount of the security transfer,[57] then such transfer is potentially preferential. Unlike the previous example, it has the effect of reducing a prepetition collateral deficiency. If the deficiency is extinguished, then the security transfer converts the status of the creditor's claim from either unsecured or undersecured to fully secured or oversecured.[58] If the deficiency is not entirely reduced, pursuant to the bifurcation scheme of the Code, the security transfer will have increased the amount of the creditor's secured claim with a corresponding reduction in the amount of its unsecured claim.[59] Again, one can illustrate either scenario by subtracting the amount of the security transfer from the value of the collateral that secures the underlying claim and then going forward with an analysis of the secured status of the claim.

A showing of reduction in collateral deficiency does not by itself establish preferential effect. In addition, claims in the class to which the transferee's unsecured claim belongs must not be paid in full.[60] If the dividend to the class is 100%, then the security transfer does not have preferential effect. The transferee is entitled to payment in full of both its secured and unsecured claims. If, however, the dividend to the class is less than 100%, the security transfer enables the transferee to receive a 100% dividend on that portion of the secured claim that would have been characterized as unsecured absent the transfer.[61]

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transfer.

55. *See infra* Appendix, equation (2).

56. If a transferee is allowed an additional secured claim for fees, costs, or charges in connection with the agreement under which the originally allowed secured claim arose, a prepetition security transfer to such a transferee may result in a preference with respect to the additional secured claim. Because a claim for fees, costs, or charges in connection with an underlying allowed secured claim is a secured claim to the extent that the value of the collateral exceeds the amount of the underlying allowed secured claim, *see* 11 U.S.C. § 506(b) (2000), a prepetition security transfer may potentially increase the amount of the transferee's secured claim for costs depending on the ratio of collateral to debt. To determine whether such a security transfer has a preferential effect, the trustee should conduct an independent analysis of the transferee's claim for costs. Such a consideration with respect to a claim for postpetition interest is irrelevant since the greater amount test of § 547(b)(5) is that of a hypothetical liquidation on the petition date. *See supra* notes 31-35 and accompanying text. *But see* Carlson, *supra* note 13, at 258 (noting that "[i]f the hypothetical chapter 7 proceeding conjured from § 547(b)(5)(A) has a life extending beyond the time of the bankruptcy petition, oversecured parties might actually get more than 100¢ on the dollar in the hypothetical liquidation because they are entitled to postpetition interest" (emphasis omitted)).

57. That is, the amount exceeds the value of the collateral less the amount of the transfer.

58. *See infra* Appendix, equation (3).

59. *See infra* Appendix, equation (4).

60. *See* Countryman, *supra* note 6, at 736.

61. *See id.*

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Table 1 sets forth the conditions outlined above under which a security transfer will have a preferential effect pursuant to the greater amount test:

TABLE 1
PREFERENTIAL EFFECT OF SECURITY TRANSFER

	Amount of Debt Owed to Transferee on Petition Date	
	Less than or equal to value of collateral on petition date minus amount of transfer	*Greater than value of collateral on petition date minus amount of transfer*
Creditor class dividend = 100%	no preferential effect	no preferential effect
Creditor class dividend < 100%	no preferential effect	preferential effect

According to Table 1, the trustee needs to plead and prove the following in order to satisfy his burden of proof with respect to the preferential effect of a security transfer: (1) The transferee has an allowed claim that is not oversecured by the amount of the transfer; and (2) the dividend on the claims in the class to which the transferee's unsecured claim belongs is less than 100%. Provided these two conditions are met, a security transfer satisfies the greater amount test.

3. *Absolute Transfers*

The concern that arises with a prebankruptcy absolute transfer is that, by reducing the amount of debt owed to the transferee on the petition date, it potentially results in a corresponding decrease in the amount of any unsecured claim held by the transferee. To show the effect of such a transfer never having occurred, one merely adds the amount of the absolute transfer to the amount of debt owed to the transferee on the petition date and then proceeds with an analysis of the secured status of the claim. As a preliminary matter, absolute transfers of a transferee's own collateral do not have a preferential effect since a creditor is always entitled to its collateral.[62] Explained in terms of the greater amount test, absent the transfer, the amount of debt owing to the transferee on the petition date would have increased by the amount of the transfer, but there also would have been a corresponding

62. *See id.* at 742-43 & 743 n.169.

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increase in the value of the transferee's interest in the collateral.[63] The secured status of the transferee's claim remains unaltered by the transfer, and the transferee does not receive a greater amount by virtue thereof. Thus, as an initial matter, an absolute transfer will not have preferential effect unless it comes from a source other than the creditor's collateral (a "noncollateral source").[64] The analysis that follows presupposes an absolute transfer from a noncollateral source.

If, on the petition date, the transferee has an allowed claim that is oversecured by at least the amount of the absolute transfer,[65] then the transferee will not have received a greater amount by virtue of the transfer.[66] In such a

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63. *See* Batlan v. TransAmerica Commercial Fin. Corp. (*In re* Smith's Home Furnishings, Inc.), 265 F.3d 959, 971 (9th Cir. 2001) (Graber, J., dissenting).

64. If an absolute transfer comes from a collateral source, the trustee may be able to establish that the transfer was preferential if the transferee's lien on the collateral can be invalidated by one of various means. *See* 11 U.S.C. § 522(f) (2000) (authorizing the debtor to avoid certain liens on property to the extent the property could have been exempted by debtor); *id.* § 544 (authorizing trustee, pursuant to nonbankruptcy law, to invalidate certain transfers); *id.* § 545 (authorizing trustee to avoid certain statutory liens); *id.* § 547(b) (authorizing trustee to avoid preferential transfers); *id.* § 548 (authorizing trustee to avoid fraudulent transfers or obligations); *id.* § 549 (authorizing trustee to avoid unauthorized transfers of property of estate). Once the lien is avoided, the transferee ceases to have an interest in the collateral and the absolute transfer becomes one from that of a noncollateral source. Provided that certain conditions are met, *see infra* Table 2, the absolute transfer will have a preferential effect. *See* Countryman, *supra* note 6, at 745-46 ("Whether a creditor seeks to meet the preference challenge by asserting . . . that the payment came from his own collateral, . . . the creditor still may be vulnerable to a two-step attack by the party invoking section 547. If that party can avoid the defendant creditor's lien, then the challenged transfer becomes one made to an unsecured creditor and has a preferential effect unless this creditor would receive 100% in a Chapter 7 distribution." (footnotes omitted)); *see also id.* at 746 ("If . . . the party challenging a transfer to a secured creditor as a preference first can invalidate the creditor's lien on any ground, including the ground that the lien itself was a voidable preference under section 547, the challenging party then can treat the subsequent transfer under section 547 as one made to an unsecured creditor."); *cf.* 5 COLLIER ON BANKRUPTCY, *supra* note 32, ¶ 547.03[7], at 547-46 n.98 ("When the debtor, within the reach-back period, grants a security interest to the creditor, thereby converting it into a secured creditor, the grant of the security interest is itself a voidable preferential transfer of property, and may serve to make any subsequent payments voidable preferences."). One commentator has argued that such an approach could inappropriately lead to a double recovery by the trustee. *See* Carlson, *supra* note 13, at 251 & n.159. While the Code limits the trustee's recovery of property to a single satisfaction in the event that more than one transferee is liable, *see* 11 U.S.C. § 550(d), the issue of a double recovery that may arise from two transfers is distinct and not addressed by the Code. It is beyond the scope of this Article to determine whether such recovery should be permitted.

65. That is, the amount of debt plus the amount of the transfer is less than or equal to the value of the collateral.

66. *See infra* Appendix, equation (6); *see also* Henderson v. Nat'l Bank of Commerce (*In re* Al-Ben, Inc.), 156 B.R. 72, 75 (Bankr. N.D. Ala. 1991) (holding that payments to a transferee did not have preferential effect since the value of collateral exceeded the amount of debt owed on petition date plus the amount of payments). Courts and commentators alike have framed preferential effect analysis in part by stating that payments to a fully secured creditor are not preferences. *See, e.g.*, Comm. of Creditors Holding Unsecured Claims v. Koch Oil Co. (*In re* Powerine Oil Co.), 59 F.3d 969, 972 (9th Cir. 1995); Sloan v. Zions First Nat'l Bank (*In re* Castletons, Inc.), 990 F.2d 551, 554 (10th Cir. 1993); *In re* Prescott, 805 F.2d 719, 726 (7th Cir. 1986); Official Comm. of Unsecured Creditors v. Am. Sterilizer (*In re* Comptronix Corp.), 239 B.R. 357, 362 (Bankr. M.D. Tenn. 1999); Telesphere Network, Inc. v. Galesi (*In re* Telesphere Communications, Inc.), 229 B.R. 173, 177 (Bankr. N.D. Ill. 1999); 5 COLLIER ON BANKRUPTCY, *supra* note 32, ¶ 547.03[7], at 547-41; David Gray Carlson, *Voidable Preferences and Proceeds: A Reconceptualization*, 71 AM. BANKR. L.J. 517, 532 (1997). But this statement is neither accurate nor helpful in determining what constitutes a preferential transfer. First, as a general matter, while "fully secured creditor" can be read as shorthand for "creditor with a fully secured claim," reference to the status of the creditor's claim is more appropriate, *see* Barash v. Pub. Fin. Corp., 658 F.2d 504, 507 (7th Cir. 1981) ("The effect of § 506(a) is to classify claims, not creditors, as secured and

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scenario, increasing the amount of indebtedness does not change the secured status of the transferee's claim. Absent the transfer, the value of the collateral still would have exceeded the amount of debt, thereby entitling the transferee to payment in full. Such a transferee does not receive a greater amount by virtue of the absolute transfer.[67]

If, on the petition date, however, the transferee has an allowed claim that is not oversecured by at least the amount of the absolute transfer,[68] then the absolute transfer may have had preferential effect.[69] In such a case, the transfer reduces a prepetition collateral deficiency. If the deficiency is extinguished, then the absolute transfer converts the status of the creditor's

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unsecured. In other words, a single undersecured creditor has both a secured claim and an unsecured claim, each of which is considered in its respective class."); S. REP. NO. 95-989, at 68 (1978) (noting that § 506 "abolishes the use of the terms 'secured creditor' and 'unsecured creditor' and substitutes in their places the terms 'secured claim' and 'unsecured claim'"), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5854; H.R. REP. NO. 95-595, at 356 (1977) (same), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6312, and will help avoid any confusion in discussing preferential effect. Second, § 547(b)(5) requires that preferential effect be determined as of the petition date and not on the date of the transfer. *See supra* notes 31-35 and accompanying text. Reference to the status of the creditor's claim at the time of transfer is therefore irrelevant when pleading proof of preferential effect. Third, although the transferee's claim may have been fully secured at the time of transfer, it is possible for the value of the collateral to decrease such that the transferee's claim would be undersecured as of the petition date. A transfer in that case would potentially result in a preference. *See In re Smith's Home Furnishings, Inc.*, 265 F.3d at 964 ("[A] transfer may be avoided when the creditor is fully secured at the time of payment, but is undersecured on the petition date."); *infra* notes 70-71 and accompanying text. Finally, it is possible for a transfer to have a preferential effect notwithstanding that the claim of the transferee is fully secured on the petition date. *See In re Smith's Home Furnishings, Inc.*, 265 F.3d at 964 ("[P]ayments that change the status of a creditor from partially unsecured to fully secured at the time of petition may be preferential."); *id.* at 969 (Graber, J., dissenting) ("The mere fact that the value of a creditor's collateral exceeds the bankrupt's indebtedness in a 'snapshot' on the petition date does not establish that a creditor is fully secured for purposes of § 547(b)(5) analysis."); *infra* notes 70-71 and accompanying text. In light of the foregoing, the correct rule would state that payments to a creditor whose claim is oversecured on the petition date by at least the amount of the payments are not preferential.

67. *See* Countryman, *supra* note 6, at 739-40 ("In a variety of contexts, the Supreme Court interpreted the preference provisions of earlier Bankruptcy Acts to require that a voidable preference must 'impair' or 'diminish' the bankrupt estate. From this interpretation, some courts concluded that payments made to a fully secured creditor were not voidable preferences. The conclusion seems correct: these payments either discharged the secured debt and the lien on the debtor's property, or they reduced the amount of the debt with a corresponding increase in the value of the debtor's equity in the collateral. A more felicitous interpretation of the statute, however, would base this conclusion on the lack of preferential effect rather than on the lack of diminution of the estate. This interpretation is particularly apt under present section 547(b), in which the inquiry is whether the payment enables the creditor to receive more than the trustee would have distributed to him in a Chapter 7 case if the payment had not been made. Most of the cases applying this rule under present section 547(b) have relied on section 547(b)(5) rather than on the no-diminution-of-the-estate rationale." (footnotes omitted)). If a transferee is allowed an additional secured claim for fees, costs, or charges in connection with the agreement under which the original allowed secured claim arose, a prepetition absolute transfer to such a transferee may result in a preference with respect to the additional secured claim. *See supra* note 56 and accompanying text.

68. That is, the amount of debt plus the amount of the transfer exceeds the value of the collateral.

69. There is the additional requirement that the class of claims to which the transferee's unsecured claim belongs not be paid in full. *See* Krafsur v. Scurlock Permian Corp. (*In re* El Paso Refinery, L.P.), 171 F.3d 249, 254 (5th Cir. 1999) ("If a payment to an undersecured creditor . . . is applied to the unsecured portion of the debt, then the undersecured creditor will have recovered a greater percentage on this claim if the estate cannot pay its unsecured creditors 100% of these claims."); *In re Telesphere Communications, Inc.*, 229 B.R. at 178 ("[T]o the extent that payment of a partially secured debt reduces the unsecured portion of the debt, the payment is preferential (unless all creditors of similar priority are paid in full)."); *infra* note 76 and accompanying text.

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claim from either unsecured or undersecured to fully secured or oversecured.[70] If the deficiency is not entirely reduced, the absolute transfer increases the amount of the transferee's secured claim with a corresponding reduction in the amount of its unsecured claim.[71] Adding the amount of the absolute transfer to the amount of debt owed to the transferee on the petition date will reflect either situation.

This analysis assumes that, pursuant to ordinary business practice, the transferee accepts the absolute transfer and does not release a corresponding amount of collateral.[72] Some courts have taken the view that, when an absolute transfer from a noncollateral source is made to a transferee that holds an undersecured claim on the petition date, a rebuttable presumption exists against the transferee that the transfer was applied to the unsecured portion of the claim.[73] This presumption should apply in all situations where an absolute transfer has had the effect of reducing a prepetition collateral deficiency (in essence, allowing the transferee to bootstrap the extent to which

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70. *See infra* Appendix, equation (7); *see also In re Smith's Home Furnishings, Inc.*, 265 F.3d at 964 ("[P]ayments that change the status of a creditor from partially unsecured to fully secured at the time of petition may be preferential." (citing Porter v. Yukon Nat'l Bank, 866 F.2d 355, 359 (10th Cir. 1989))).

71. *See infra* Appendix, equation (8); *cf. In re Comptronix Corp.*, 239 B.R. at 362 ("Payments on an undersecured debt can be preferential.").

72. *See In re El Paso Refinery, L.P.*, 171 F.3d at 254 ("If . . . the creditor does not actually release collateral upon application of the payment, then the payment is ipso facto a payment on the unsecured portion of the claim."); Balfance v. BancOhio/Nat'l Bank (*In re* McCormick), 5 B.R. 726, 729 (Bankr. N.D. Ohio 1980) (noting that it is "standard business practice" for transferee to credit prepetition payments toward unsecured portion of debt); *see also* 5 COLLIER ON BANKRUPTCY, *supra* note 32, ¶ 547.03[7], at 547-46 (noting that payment to undersecured creditor from noncollateral source has preferential effect since "payment would ordinarily be applied to the unsecured portion of the undersecured debt, but would not reduce the lien or increase the debtor's equity in the collateral"); Carlson, *supra* note 13, at 271 ("[I]t remains open for a secured party to make a record that, indeed, just before bankruptcy, the secured party did intend to release collateral in exchange for payment. When this occurs, the hypothetical liquidation test cannot be met."); Countryman, *supra* note 6, at 744 (observing that an undersecured "creditor always takes the payment and retains all of his collateral"). The transfer would not have preferential effect if the transferee surrendered or released, to the extent of the transfer, his interest in the collateral. *See In re El Paso Refinery, L.P.*, 171 F.3d at 254 ("[I]f the undersecured creditor applies the payment to the secured portion of the debt, . . . its secured claim is reduced, freeing up a corresponding amount of collateral. In this situation, the creditor does not receive a greater percentage recovery."); *In re Telesphere Communications, Inc.*, 229 B.R. at 177 ("[I]f a payment is made on debt that is not fully secured, the payment will still be nonpreferential if it only reduces the secured portion of the indebtedness. . . . Given the treatment of 'secured claim' in
§ 506(a), a payment can only reduce the secured portion of a partially secured claim if it reduces the amount of collateral supporting the claim (since a payment that left the collateral intact would necessarily reduce the unsecured portion of the claim). There are only two ways to reduce the amount of a secured creditor's collateral: to return some or all of the collateral, or to make a payment from unencumbered property in exchange for a release of the lien on an equivalent amount of collateral."); Countryman, *supra* note 6, at 744 ("[I]f a creditor who is only partially secured received a payment from any of the debtor's property not covered by the creditor's lien, the payment has preferential effect. That result could be avoided. The creditor could apply the payment to the secured part of his claim by releasing a corresponding amount of collateral." (footnote omitted)).

73. *See, e.g.*, Seitz v. Yudin (*In re* Cavalier Indus., Inc.), 2002 WL 975868, at *3 (Bankr. E.D. Pa. Apr. 16, 2002) ("[T]here is a presumption that an undersecured creditor will apply any transfer it receives from the debtor to the unsecured portion of its debt."); *In re McCormick*, 5 B.R. at 729 ("The Court must assume, *in the absence of proof to the contrary*, that the payments were credited towards the unsecured portion of the debt, since this course of action would comport with standard business practice." (emphasis added)).

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its claim is secured), which can be demonstrated by the trustee through application of the greater amount test—that is, by establishing that the amount of debt on the petition date, in addition to the amount of the transfer, is greater than the value of the collateral on the petition date.

When a transferee receives payment prior to bankruptcy, it receives a 100% distribution on a portion of its unsecured claim. Thus, while only a portion of the unsecured debt owed to the transferee is paid on a pro rata basis (i.e., the original amount of the unsecured debt minus the amount of the transfer), each other creditor in the class is paid on a pro rata basis on the *entirety* of its claim.[74] This invariably enables the transferee to enjoy a greater recovery by virtue of the prepetition transfer.[75] Accordingly, distribution to the class of claims to which the transferee's unsecured claim belongs must be less than 100% for the transferee to have enjoyed a greater recovery.[76]

Table 2 sets forth the conditions outlined above under which an absolute transfer of noncollateral will have a preferential effect pursuant to the greater amount test:

74. *See, e.g.*, Palmer Clay Prods. Co. v. Brown, 297 U.S. 227, 229 (1936) ("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 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."); *In re McCormick*, 5 B.R. at 729 ("In liquidation, BancOhio would have received payment on this unsecured claim only on a pro-rata basis with other unsecured creditors. If the two . . . payments . . . were credited to the unsecured balance on the debtor's account, BancOhio received more than it would have received on a pro-rata basis with other unsecured creditors, who have as yet received no dividends at all.").

75. *See* Comm. of Creditors Holding Unsecured Claims v. Koch Oil Co. (*In re* Powerine Oil Co.), 59 F.3d 969, 972 (9th Cir. 1995) ("'[A]s long as the distribution in bankruptcy is less than one-hundred percent, *any* payment 'on account' to an unsecured creditor during the preference period will enable that creditor to receive more than he would have received in liquidation had the payment not been made.'" (alteration in original) (quoting Elliot v. Frontier Properties/LP (*In re* Lewis W. Shurtleff, Inc.), 778 F.2d 1416, 1421 (9th Cir. 1985))); Countryman, *supra* note 6, at 736 ("[A] preferential effect exists if the trustee can establish that a defendant unsecured, nonpriority creditor, without the allegedly preferential payment or lien, would have received less than a 100% payout in a Chapter 7 liquidation. The result continues to seem sensible for the same reason it did under *Palmer Clay Products*—either because the preferential transfer covered 100% of defendant's claim or, if the transfer covered less, because the defendant would get on the unsecured balance the same dividend that other creditors in his class would get on 100% of their claims." (footnote omitted)).

76. *See* Countryman, *supra* note 6, at 738 ("If the dividend to the defendant-creditor's class in a Chapter 7 liquidation would be less than 100%, the challenged transfer has preferential effect."). Where the distribution to the creditor class is 100%, the trustee could satisfy his burden by showing that the transfer was made on account of a claim that was disallowed in whole or in part pursuant to § 502(b). 11 U.S.C. § 502 (2000) (setting forth grounds on which a claim may be disallowed). Since the transferee would not receive a distribution in the case to the extent the court deemed the claim disallowed, any transfer in excess of the allowed amount of the claim would constitute a preference. *See* S. REP. NO. 95-989, at 87 (1978) ("The language [of § 547(b)(5)] also requires the court to focus on the allowability of the claim for which the preference was made. If the claim would have been entirely disallowed, for example, then the test of paragraph (5) will be met, because the creditor would have received nothing under the distributive provisions of the bankruptcy code."), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5873; H.R. REP. NO. 95-595, at 372 (1977) (same), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6328.

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TABLE 2
PREFERENTIAL EFFECT OF ABSOLUTE TRANSFER OF NONCOLLATERAL

	Amount of Debt Owed to Transferee on Petition Date Plus Amount of Transfer	
	Less than or equal to value of collateral on petition date	*Greater than value of collateral on petition date*
Creditor class dividend = 100%	no preferential effect	no preferential effect
Creditor class dividend < 100%	no preferential effect	preferential effect

According to Table 2, the trustee needs to plead and prove the following to satisfy his burden of proof with respect to the preferential effect of an absolute transfer: (1) The transfer is from a noncollateral source; (2) the transferee is not oversecured by the amount of the transfer; and (3) the dividend paid to claims in the class to which the transferee's unsecured claim belongs is less than 100%.[77] Provided these conditions are satisfied, an absolute transfer satisfies the greater amount test.

C. Overenforcement and Underenforcement Concerns

My goal in having proposed the foregoing framework that standardizes the pleading of proof for preferential effect is to promote a uniformity and certainty that properly bound the reach of preference law. Formal rules, generally speaking, provide parties with a sense of certainty of the outcome that should result from any given set of facts. We may initially think that the primary benefit of uniformity and certainty is that creditors will know the boundary of conduct that will subject them to preference attack. If they do not transgress the boundary, the costs associated with preference recovery are reduced. Moreover, such rules will encourage creditors to transact with a financially troubled debtor since they will be able to limit their exposure to a preference avoidance action through calculated behavior. These arguments, however, fall within the rationale of deterrence. Because preference law does not likely deter a creditor from taking a preference,[78] one neither

77. Pursuant to the presumption discussed above, *see supra* note 73 and accompanying text, a pleading that an absolute transfer was made to a transferee with a prepetition collateral deficiency would impose on the transferee the burden of going forward with evidence that the transfer was applied to the secured portion of the claim. *See* FED. R. EVID. 301.

78. *See supra* note 13.

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cannot nor should not expect that costs associated with prebankruptcy "opt-out" behavior by creditors could be eliminated by adherence to such rules.[79]

Recall that the equality principle drives preference law.[80] If preference law is to be given its proper effect and thus eliminate unnecessary costs, we must ensure that its application is balanced. Where a trustee excessively overreaches his power (overenforcement) or where a court fails to apply the law properly (underenforcement), the equality principle has been compromised. A model for preferential effect attempts to strike an equilibrium where overenforcement and underenforcement cease to be of concern.

The potential for overenforcement arises from the confluence of two factors: (1) a much greater power under the Code to avoid preferences by virtue of a preference provision that is broader in scope than under the Bankruptcy Act;[81] and (2) the manner in which the Code confines the initial inquiry of preferential effect to the idea of greater amount without regard or reference to the statutory defenses that may negate such effect.[82] The attempt to cabin the broad reach of the trustee's preference net by providing exceptions thereto,[83] ironically, has not been fully successful by virtue of the fact that the transferee must establish the defense.[84] Assuming that a valid defense exists to the trustee's preference attack and that the defense can be properly proffered for the transferee to satisfy its burden of proof, a transfer that should not be deemed a preference will nonetheless be considered as such until the defense has been asserted.[85]

Arguably, in such an instance, the trustee should exercise discretion and not bring the preference action. Concern exists, however, that unnecessary and undesirable costs result from improvident preference litigation by trustees.[86] The rules proposed in this Article for proof of preferential effect

79. That said, any deterrent benefit that does inhere is always welcome. For treatment regarding preference law as a response to "prebankruptcy opt-out activity" by creditors, *see* JACKSON, *supra* note 1, at 122-46.

80. Adams v. Pugliese (*In re* Sevitski), 151 B.R. 590, 594 (Bankr. N.D. Okla. 1993).

81. *See infra* Part II.A.

82. *See* Ponoroff, *supra* note 6, at 1504 n.191.

83. *See id.* at 1480 (observing that statutory defenses to trustee's preference action "can be explained, in part, by the need to temper the vastly expanded scope of the trustee's preference power resulting from the simultaneous elimination of a *mens rea* test and the incorporation of a statutory presumption of insolvency").

84. *See id.* at 1480 n.116 ("Of course, mitigating the impact of the preference exceptions is § 547(g), which places the burden of establishing the non-avoidability of a preference under any of the categories of § 547(c) on the defendant-transferee.").

85. *See id.* at 1504 n.192 ("Expanding the inquiry under § 547(c), rather than § 547(b)(5), places on the creditor the burden of establishing that the challenged transfer, in isolation clearly a preference, did not in the end impinge on the value which the preference law is designed to protect.").

86. The National Bankruptcy Review Commission in its analysis of procedural preference reforms has expressed a general concern that certain preference actions may not be meritorious. 1 NAT'L BANKR. REVIEW COMM'N, BANKRUPTCY: THE NEXT TWENTY YEARS 796 (1997) ("[A]lthough the theory and substance of the preference power are sound, the practice of preference recovery is somewhat flawed. The concern is whether section 547 leads to abusive preference recovery suits by bankruptcy trustees who bring actions indiscriminately, without properly analyzing the creditor's available defenses and because the litigation costs associated with defending these actions outweigh the settlement amount the trustee is willing to accept.").

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should aid a trustee in focusing more of his resources on evaluation of the strengths and weaknesses—as opposed to the merits—of his preference attack in light of possible defenses thereto. Although the power of avoidance is a potent one, it is incumbent upon the trustee to use it in a tempered manner that creates, rather than destroys, value for the estate. A principled approach to proof of preferential effect therefore strikes an appropriate balance between application and use of the greater amount test and does not result in overenforcement.

The potential for underenforcement, on the other hand, arises when a court improperly construes the greater amount test by exacting a more demanding burden of proof on the trustee than that required by the Code: Transfers that should be captured by the trustee's preference net will slip through. A court should not deny the trustee's avoidance power its full statutory reach, for to do so allows a creditor to be preferred, thereby eroding the equality principle. To demonstrate how a standard pleading of proof clarifies any ambiguity that may exist in application of the test for preferential effect, this Article turns to an example of unwarranted judicial deviation from the greater amount test in the context of absolute transfers.

II. REVISITING PROOF OF PREFERENTIAL EFFECT

Application of the greater amount test most often arises where the creditor has made a single advance of credit to the debtor and where there is a fixed amount of collateral, if any at all, securing the debt. In *In re Smith's Home Furnishings, Inc.*, however, the Ninth Circuit considered the burden of proof on a trustee to show that a series of prebankruptcy payments to a creditor with a floating lien on a debtor's inventory constitutes a voidable preference.[87] Under a floating lien, a creditor extends credit presently and in the future in exchange for a security interest in both existing and after-acquired collateral—usually inventory or accounts receivable and the proceeds thereof.[88] As a debtor sells inventory to repay the loan, the lien will "float" to cover proceeds from the sale, in addition to any new inventory the debtor may later acquire. Concerned that the mass of collateral and the amount of indebtedness constantly fluctuate under a floating lien, the Ninth Circuit deviated from the generally accepted rule that the greater amount test calls for a hypothetical liquidation on the petition date.[89] Instead, it ruled that the trustee had to establish that the floating lien creditor was un-

87. Batlan v. TransAmerica Commercial Fin. Corp. (*In re* Smith's Home Furnishings, Inc.), 265 F.3d 963 (9th Cir. 2001).

88. U.C.C. § 9-204 (1998) (providing for security interest in after-acquired collateral); *id.* § 9-205 (validating a security interest in a debtor's existing and future assets, despite the fact that the debtor may have a right to dispose of collateral without accounting to a secured party for proceeds or substituting new collateral).

89. *See supra* text accompanying notes 31-35.

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dersecured at some point during the preference period to satisfy his burden of proof.[90]

This Part sets forth the proposition that a court undermines the equality principle when it establishes an evidentiary rule that improperly departs from the greater amount test. Part II.A examines the manner in which Congress has (1) eased a trustee's burden of proof to establish preferential effect and (2) facilitated the trustee's preference attack on a floating lien creditor. Against this backdrop, Part II.B details the Ninth Circuit's decision. Part II.C rejects the rule established by the court on several grounds. First, it argues that the court's holding does not square with the application of the greater amount test as informed by the Supreme Court's decision in *Palmer Clay Products Co.* Second, it suggests that the historical development of the preference provision further warrants adherence to the evidentiary requirements of the greater amount test. The Article concludes by urging that failure to give effect to state law presumptions that favor the trustee, as did the Ninth Circuit, contravenes the equality principle.

A. *Expanding the Trustee's Preference Power*

1. *Evolution of the Trustee's Evidentiary Burden*

Preference law has evolved with the general trend of making its reach broader in scope, thereby allowing a trustee to recover more prebankruptcy transfers for the benefit of a debtor's estate. In discussing a trustee's evidentiary burden to establish the elements of a preferential transfer, it is important to consider the changes that have culminated in the Code's preference provision. First, by eliminating the "reasonable cause to believe" requirement that existed under the Bankruptcy Act, Congress has broadened the class of creditors subject to a trustee's preference attack, and in doing so has made a showing of preferential transfer administratively less complex.[91] Second, the presumption of a debtor's insolvency during the ninety-day period preceding bankruptcy has eased the trustee's evidentiary burden.[92] These changes can be viewed as part of the general process to strike the proper balance between secured and unsecured creditors, a process that has required a shift away from favoring the secured creditor's position in bankruptcy as much as was previously the case under the Bankruptcy Act.[93] This section will consider each change in turn.

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90. *See infra* note 168 and accompanying text.

91. *See infra* notes 94-100 and accompanying text.

92. *See infra* notes 105-07 and accompanying text.

93. *Cf.* Arthur J. Harrington, *Insecurity for Secured Creditors—The Floating Lien and Section 547 of the Bankruptcy Act*, 63 MARQ. L. REV. 447, 447 (1980) ("Since the . . . original preferential transfer provisions in the Bankruptcy Act of 1898, a constant battle has been waged in the bankruptcy forum between secured and unsecured creditors for rights in after-acquired property of the debtor. Section 547 represents a compromise between these warring factions. This compromise has evolved through numerous changes in the preferential transfer provision of the Bankruptcy Act since the 1898 Act."); Nimmer, *supra* note 49, at 305 ("Section 547 represents a compromise that significantly reverses a trend favorable

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The preference provision of the Code is the product of a gradual and ever-broadening departure from its English origins in fault-based criteria with the result that the statute refers to objective factors, rather than subjective factors, to define the type of transfers that constitutes a preference.[94] Section 547 of the Code markedly contrasts with its predecessor under the Bankruptcy Act, which required a trustee to prove that a creditor had "reasonable cause to believe" that the debtor was insolvent before a transfer could be avoided.[95] The Code does not make any reference to a creditor's "reasonable cause" to know of the debtor's insolvency.[96] The impetus to eliminate this requirement stemmed from the fact that, to promote equality of distribution among similarly situated creditors, it was immaterial whether a transferee knew it had received a preference.[97] This change signifies the complete transformation of preference law to a no-fault regime where avoidability of a transfer is no longer dependent on a culpable act of the

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to secured creditors that had begun with the general adoption of Article 9 of the Uniform Commercial Code.").

94. *See* Countryman, *supra* note 6, at 747 ("Thus, we have finally come . . . to a voidable preference concept that abandons the English requirement of the debtor's culpability and our own former requirement of the creditor-defendant's culpability."); Richard F. Duncan, *Preferential Transfers, the Floating Lien, and Section 547(c)(5) of the Bankruptcy Reform Act of 1978*, 36 ARK. L. REV. 1, 40 (1983) ("The Bankruptcy Reform Act has shaped a policy that attempts to move beyond . . . historical development by adopting an approach to the preference problem that is both objective and purposive."); McCoid, *supra* note 4, at 259 ("Preference law has thus moved from a notion of debtor fraud to a standard of absolute liability for a limited period for preferred creditors."). *See generally* Countryman, *supra* note 6, at 714-25; McCoid, *supra* note 4, at 250-59, for a discussion of the differences between the English and American concepts of a preference and the manner in which those concepts developed.

95. Act of June 22, 1938, ch. 575, § 60b, 52 Stat. 840, 870 (repealed 1978) ("Any such preference may be avoided by the trustee if the creditor receiving it or to be benefited thereby or his agent acting with reference thereto has, at the time when the transfer is made, reasonable cause to believe that the debtor is insolvent."). While preference law originally referred to the debtor's state of mind, specifically the debtor's intent to give the creditor a preference, that requirement was eliminated and replaced with reference to the creditor's state of mind—initially knowledge of the debtor's intention to prefer the creditor, subsequently knowledge of the preferential effect of the transfer, and finally knowledge of the debtor's insolvency. *See* McCoid, *supra* note 4, at 253-59.

96. While § 547(b)(4) as originally enacted required a trustee to establish that an insider had reasonable cause to believe the debtor was insolvent at the time of the transfer, *see* 11 U.S.C. § 547 (b)(4)(B) (1982), the Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, § 454, 98 Stat. 333, 375-76, eliminated the requirement.

97. *See Bankruptcy Act Revision: Hearings Before Subcomm. on Civil and Constitutional Rights of the House Judiciary Comm. on H.R. 31 and H.R. 32*, 94th Cong. 1855 (1976) [hereinafter *Hearings*] (statement of Mr. Leon Forman, Spokesman, National Bankruptcy Conference) ("Logically and theoretically, the knowledge of the receipient [sic] of the preference has nothing to do with equality of distribution. Equality is determined by the fact that all creditors are being treated reasonably alike. So, if two creditors received a payment . . . and one had knowledge and one did not of the insolvency of the debtor, that has really no relevancy to equality of treatment."); H.R. REP. NO. 95-595, at 178 (1977) ("[A] creditor's state of mind has nothing whatsoever to do with the policy of equality of distribution, and whether or not he knows of the debtor's insolvency does little to comfort other creditors similarly situated who will receive that much less from the debtor's estate as a result of the prebankruptcy transfer to the preferred creditor. To argue that the creditor's state of mind is an important element of a preference and that creditors should not be required to disgorge what they took in supposed innocence is to ignore the strong bankruptcy policy of equality among creditors."), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6139; *see also* Ponoroff, *supra* note 6, at 1449 ("[I]f the goals of preference legislation are to maximize estate value and preserve the effectiveness of the distributional scheme in bankruptcy, a transfer that depletes the value of the estate threatens those values without regard to the debtor's or the transferee-creditor's state of mind . . . .").

creditor,[98] but rather on the economic benefit conferred on the creditor. The Code defines preference solely with respect to a transfer's effect on the distribution a creditor would have received absent the transfer.[99] Aside from its normative implication for achieving an objective definition of a voidable preference, the significance of eliminating the "reasonable cause to believe" requirement has been its impact on a trustee's evidentiary burden to demonstrate the avoidability of a transfer.[100]

Under the Bankruptcy Act, proving avoidability involved a highly subjective and fact-sensitive process involving the trustee's proof of a creditor's knowledge and the legal consequences thereof.[101] This evidentiary burden clearly had the effect of limiting a trustee's avoidance power.[102] Because a trustee's factual burden today is solely confined to proving objective factors (e.g., antecedent indebtedness, insolvency, and timing of the transfer),[103] thereby obviating case-by-case consideration of the avoidability of a transfer once the elements of a preference have been satisfied, the process by which a trustee satisfies the elements of a preferential transfer has become administratively less complex.[104] Moreover, elimination of the "rea-

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98. *See* Barash v. Pub. Fin. Corp., 658 F.2d 504, 510 (7th Cir. 1981) ("[T]he creditor's knowledge or state of mind is no longer relevant. Under the predecessor to § 547 (§ 60 of the Bankruptcy Act of 1898), the Trustee had to establish that the creditor had 'reasonable cause to believe' that a debtor was insolvent before a transfer could be avoided. Congress eliminated this requirement in favor of the objective criteria under the new Code."); *see also supra* note 94.

99. 11 U.S.C. § 547(b)(5) (2000); *see* 5 COLLIER ON BANKRUPTCY, *supra* note 32, ¶ 547.01, at 547-9 to 547-10 ("The debtor's intent or motive is not material in the consideration of an alleged preference under section 547. Generally speaking, it is the *effect* of the transaction, rather than the debtor's or creditor's *intent*, that is controlling." (footnote omitted)). But that is not to say that subjective factors no longer play any role in establishing the preferential effect of a transfer. *See id.* ¶ 547.01, at 547-10 n.7 ("The debtor's or creditor's intent, however, may be a dispositive factor in determining certain elements of a preference under 11 U.S.C. § 547(b) or exceptions contained in 11 U.S.C. § 547(c)."). *See* Ponoroff, *supra* note 6, *passim*, for the argument that preference analysis should be solely confined to consideration of objective factors.

100. *See Hearings*, *supra* note 97, at 1855 (statement of Mr. Leon Forman, Spokesman, National Bankruptcy Conference) ("[T]his element has been a constant source of litigation. It has been used by creditors more or less as a shield. There are a great many cases where the creditor was well aware of the financial difficulties of the debtor but managed to escape the recovery of a preference because the trustee just was not able to meet the burden of proof.").

101. *See* Barkley Clark, *Preferences Under the Old and New Bankruptcy Acts*, 12 UCC L.J. 154, 156 (1979) ("The bankruptcy court first examines what the creditor knew about the debtor's financial position; then it applies the rules as to the legal consequences of what he knew.").

102. *See* H.R. REP. NO. 95-595, at 178 ("[T]he requirement that the trustee prove the state of mind . . . is nearly insurmountable, and defeats many preference actions. The amount of litigation it causes is too great when the requirement itself does not further any necessary bankruptcy policy." (footnote omitted)), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6139; *cf.* Clark, *supra* note 101, at 155 ("It cannot be overemphasized that the trustee has the burden of proof on this factual issue [i.e., "reasonable cause to believe"]; if he fails to meet this burden, the preference is not avoidable and the creditor can keep the repayment. In this regard, the trustee's avoidance power under Section 60 is not nearly as handy as his lien creditor power under Section 70(c), where there is no factual burden to meet." (footnote omitted)).

103. *See* Nimmer, *supra* note 49, at 291 ("Avoidance is premised solely on the occurrence of an economic benefit received by a creditor under specified circumstances.").

104. *See* Clark, *supra* note 101, at 162-63 ("[T]he impact of the Bankruptcy Reform Act's preference provision on Article 9 transactions will be substantial insofar as it will exchange a case-by-case 'reasonable cause' test for a much more mechanical ninety-day standard in all but 'insider' cases."); Nimmer, *supra* note 49, at 293 ("[S]ection 547 represents a conscious redirection of prior law justified by considerations involving ease of administration and the predominant role of 'equal distribution' policies. As a

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sonable cause to believe" requirement has broadened the class of creditors subject to a trustee's preference attack: Under the Code, the state of mind of a creditor can no longer shield a transfer from a trustee's preference attack. Thus, a preferential transfer that could not be avoided under the Bankruptcy Act because of insufficient evidence regarding the creditor's state of mind today falls in the category of avoidable preference.

Finally, to further ease the trustee's evidentiary burden, Congress created the presumption that a debtor is insolvent during the ninety days preceding the petition date.[105] While the presumption does not relieve the trustee of his burden to establish that the debtor was insolvent at the time of transfer,[106] its practical effect has been to obviate the need for the trustee to present any evidence with respect to that element.[107] The combination of a larger class subject to a preference attack and a relaxed burden of proof have greatly increased the avoidance powers of a trustee.[108]

2. *Redefining the Timing of Transfer*

Congress not only has gone to great lengths to broaden the reach of preference law generally, but it has also targeted specific transfers—among them transfers to a floating lien creditor—in its efforts to make the law as comprehensive as possible. This has been accomplished, in large part, by redefining the timing of a transfer.

The concept of when a transfer occurs for purposes of preference analysis has been one aspect of congressional efforts to harmonize the tension between protecting transfers to individual creditors during the preference period and increasing the distribution made to unsecured creditors. Note that, in proving the avoidability of a transfer, four of the five elements re-

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result of this redirection, a premium is placed on identifying exactly what economic effects contravene the purposes of preference law.").

105. Countryman, *supra* note 6, at 726 (noting that reduced preference period from 120 to 90 days was seen "as a rough trade-off for easing the trustee's evidentiary burden" that resulted from elimination of "reasonable cause to believe" requirement and adoption of presumption of debtor's insolvency).

106. *See* FED. R. EVID. 301; *see also* S. REP. NO. 95-989, at 89 (1978) ("The presumption [in § 547(f)] is as defined in Rule 301 of the Federal Rules of Evidence . . . . The presumption requires the party against whom the presumption exists to come forward with some evidence to rebut the presumption, but the burden of proof remains on the party in whose favor the presumption exists."), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5875; H.R. REP. NO. 95-595, at 375 (same), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6331.

107. Countryman, *supra* note 6, at 729-30 ("One consequence of the Reform Act changes, as the reported cases reveal, has been that, in most cases, the creditor-defendant in a preference action makes no effort to rebut the section 547(f) presumption of the debtor's insolvency within the ninety day pre-bankruptcy period, and the presumption carries the day for the trustee or other party attacking the preference on the insolvency issue." (footnotes omitted)); *see also* Ponoroff, *supra* note 6, at 1512 n.219 (citing Countryman for same proposition and noting that, in six-year period following publication of Countryman's article, transferee-defendants generally did not challenge presumption of insolvency).

108. *See* Clark, *supra* note 101, at 162 (noting that elimination of "reasonable cause to believe" requirement "should greatly aid trustees in fighting late-perfected security interests under Article 9: It will clearly support the policy of equal distribution among creditors by strengthening the avoidance power of the trustee.").

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quire reference to the date of transfer.[109] Since the trustee's burden of proof requires him to establish all five elements of a preferential transfer,[110] Congress has significantly alleviated that burden by providing "a clear and exhaustive formulation of when a transfer is made for purposes of bankruptcy preference analysis."[111] The difficulty encountered by a trustee under the Bankruptcy Act to establish that a transfer of a security interest in after-acquired collateral occurred during the preference period provides a sharp contrast to the ease with which the trustee can make such a showing today.

Under the Bankruptcy Act, a variety of judicial exceptions emerged that immunized security interests acquired under a floating lien from a trustee's preference attack,[112] most prominent among them the "so far perfected" theory.[113] Pursuant to the 1950 amendment to the Bankruptcy Act, a transfer occurred for purposes of preference analysis at the point when a secured party perfected its security interest such that no subsequent lien creditor could obtain priority over the secured party (the "lien creditor test").[114]

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109. 5 COLLIER ON BANKRUPTCY, *supra* note 32, ¶ 547.03[7], at 547-44. The four elements are the creditor's benefit, antecedent indebtedness, insolvency, and the ninety-day preference period. 11 U.S.C. § 547(b)(1)-(4) (2000). Under the Bankruptcy Act, the timing of a transfer was equally significant. *See* 3 COLLIER ON BANKRUPTCY pt. 2, ¶ 60.36, at 913 (James Wm. Moore & Lawrence P. King eds., 14th ed. 1977) ("[A]ll elements of a voidable preferential transfer, save the sixth (the 'greater percentage') which is determined in light of the actual results of bankruptcy, are determined as of the time when the transfer was 'made or suffered.'"). Adding to a trustee's burden of proof, in order to avoid a preference under the Bankruptcy Act, a trustee had to show that, at the time of the transfer, the creditor had "reasonable cause to believe that the debtor [was] insolvent." Act of June 22, 1938, ch. 575, § 60(b), 52 Stat. 840, 870 (repealed 1978). For a discussion of the "reasonable cause to believe" requirement, see *supra* Part II.A.1.

110. *See supra* note 24.

111. Duncan, *supra* note 94, at 13.

112. *See* 5 COLLIER ON BANKRUPTCY, *supra* note 32, ¶ 547.05[5], at 547-68 n.60 (observing that, under the Bankruptcy Act, "[c]ourts . . . developed judicial exceptions to protect the secured position of creditors with 'floating liens'"); Clark, *supra* note 101, at 175 (noting that, under the Bankruptcy Act, "courts have almost uniformly held in favor of the secured creditor" with a floating lien); Duncan, *supra* note 94, at 12 ("[T]he case law under the Former Act erected an almost impenetrable, protective barrier around perfected security interests attaching to collateral during the preference period pursuant to after-acquired property clauses in valid pre-existing security agreements."); Harrington, *supra* note 93, at 447-48 ("Prior to the enactment of section 547, . . . judicial theories virtually insulated a floating lien creditor from attack under the preferential transfer section of the Bankruptcy Act."); Nimmer, *supra* note 49, at 307 ("[T]he authoritative case law under the old Act held that security interests acquired under a floating lien did not constitute preferential transfers. This result was achieved under a variety of theories.").

113. *See* Harrington, *supra* note 93, at 466 ("The so far perfected theory seems to have gained the most popularity with jurists who have upheld the validity of security interests in after-acquired property against attack as a preference. This theory is based upon the so far perfected language contained in section 60a(2)." (footnote omitted)); Anthony T. Kronman, *The Treatment of Security Interests in After-Acquired Property Under the Proposed Bankruptcy Act*, 124 U. PA. L. REV. 110, 127 (1975) ("The third and perhaps most popular argument supporting the Article 9 floating lien turns upon analysis of the different perfection requirements of section 60a(2) of the Bankruptcy Act and section 303 of Article 9." (footnote omitted)); *see also* Duncan, *supra* note 94, at 7 ("The 'so far perfected' theory was based on language in section 60(a)(2) of the Former Act . . . ."). The other prevailing theories were (1) the entity theory, (2) the substitution of collateral theory, and (3) the UCC § 9-108 theory. *See* Clark, *supra* note 101, at 173-75 (discussing theories); Duncan, *supra* note 94, at 5-7, 8-9 (same); Harrington, *supra* note 93, at 463-65, 468-69 (same).

114. Act of Mar. 18, 1950, ch. 70, § 1(2), 64 Stat. 24, 25 (repealed 1978) ("[A] transfer of property other than real property shall be deemed to have been made or suffered at the time when it became so far perfected that no subsequent lien upon such property obtainable by legal or equitable proceedings on a simple contract could become superior to the rights of the transferee.").

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While the Bankruptcy Act relied on reference to state law to indicate when perfection occurred,[115] it limited such reference to the "so far perfected" concept.[116] A disconnect resulted whereby the perfection requirements of the Uniform Commercial Code (the "UCC") did not mirror the concept of perfection for purposes of preference analysis under the Bankruptcy Act.[117]

Generally speaking, a creditor's security interest in collateral cannot be perfected until the interest attaches,[118] and attachment does not occur until the debtor has acquired rights in the collateral.[119] State law would thus deem the time of perfection and the transfer of the security interest to occur no earlier than when the debtor acquires rights in the collateral. As applied by courts under the so far perfected theory, however, the lien creditor test related the timing of the transfer of a security interest acquired under a floating lien back to the filing of a financing statement by the secured party.[120] From the rule that a lien creditor can only achieve priority over a security interest that has already attached prior to its perfection,[121] it followed that no opportunity existed for a lien creditor to establish a claim superior to a secured party that previously filed a financing statement since the security interest immediately attached and simultaneously perfected upon the

115. *See* 3 COLLIER ON BANKRUPTCY, *supra* note 109, pt. 2, ¶ 60.39[2], at 959 ("[T]he question of perfection of a particular transfer as against subsequent lien creditors in the case of personal property . . . is one of substantive law to which only state statutes and state court decisions can normally supply the conclusive answer.").

116. *See* DuBay v. Williams, 417 F.2d 1277, 1287-88 (9th Cir. 1969) ("We look to state law, therefore, only to decide the point at which Rose City's claim to the future accounts was sufficiently asserted to prevent a subsequent lien creditor from achieving priority over it in those accounts."); Grain Merchs. of Ind., Inc. v. Union Bank & Sav. Co., 408 F.2d 209, 212 (7th Cir. 1969) ("Reference to state law is necessary to determine whether a secured creditor has 'so far perfected' his lien as to cut off the rights of a subsequent lien creditor under Section 60a(2) of the Bankruptcy Act."); Owen v. McKesson & Robbins Drug Co., 349 F. Supp. 1327, 1331-32 (N.D. Fla. 1972) ("[P]erfection under state law need not be full perfection but only perfection so far as is necessary to meet the test of § 60(a)(2)."); Clark, *supra* note 101, at 174 ("Section 60 does not require that a security interest be 'perfected' before the transfer takes place, only that it be 'so far perfected' that lien creditors cannot get priority."); Harrington, *supra* note 93, at 467 ("Under the [so far perfected] theory, one only looks to state law to determine at what point in time the secured party took the steps necessary to prevent a subsequent lien creditor from achieving priority over the secured party's claim in the after-acquired property of the debtor.").

117. *See Owen*, 349 F. Supp. at 1331 ("Even though perfection of the security interest under the Code may not have been accomplished because the security interest in property had yet to attach, for bankruptcy purposes § 60(a)(2) will treat the secured interest as indefeasible where it cannot be defeated by a subsequent lien creditor."); Kronman, *supra* note 113, at 127-28 ("The [Bankruptcy] Act does not demand the state of absolute perfection, including attachment, defined by [UCC] section 9-303. The process of perfection may reach the stage necessary for a transfer under the Act prior to perfection under Article 9." (footnote omitted)).

118. U.C.C. § 9-308(a) (1998). Despite the revisions made to Article 9 of the Uniform Commercial Code since the time when courts applied the so far perfected theory, the general rules and principles of Article 9 that provided in part the basis for the theory still apply today. The Article therefore cites to the current version of Article 9.

119. *Id.* § 9-203(a), (b)(2).

120. *See, e.g.*, *DuBay*, 417 F.2d at 1287-88; *Grain Merchs. of Ind., Inc.*, 408 F.2d at 212-13. While in practical terms the Seventh Circuit in *Grain Merchs. of Ind., Inc.* related the transfer back to recordation, the court disavowed any such notion. *See id.* at 214-15 (noting that its holding relied on "the relation forward of record notice prior to the 4-month pre-bankruptcy period as being sufficient to give the secured party a priority over subsequently attaching lien or judgment creditors, including the trustee.").

121. U.C.C. § 9-317(a)(2)(A).

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debtor's acquisition of the collateral.[122] By virtue of the theory's gloss on the lien creditor test, the trustee could never satisfy his evidentiary burden to establish that the transfer of a security interest in after-acquired collateral to a floating lien creditor occurred during the preference period.[123] The theory arguably led to an absurd result that Congress never intended.[124]

When it enacted the Code, Congress resolved the inequity that resulted from judicial application of the lien creditor test by providing that "a transfer is not made until the debtor has acquired rights in the property transferred."[125] Although the Code still relies on the concept of perfection for determination of when a transfer is made for purposes of preference analysis,[126] the floor established in the Code eliminates any disconnect with UCC perfection requirements.[127] Congress's explicit rejection of the so far perfected theory can be interpreted to reflect its disagreement with the view that the theory comported with the policy and purpose of the Bankruptcy Act.[128] The redefinition of the timing of a transfer can be viewed as part of

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122. *See* Duncan, *supra* note 94, at 7 n.29 ("Since the security interest in after-acquired collateral would be perfected under the earlier filing, at the moment the security interest attached (i.e., upon the debtor's acquiring the rights in collateral), the best a lien creditor of the debtor could achieve would be a draw."); Harrington, *supra* note 95, at 467 n.75 ("Since attachment is immediate, there is simply no intervening time between the debtor's acquisition of the collateral and perfection of the secured party's rights in the goods during which the lien creditor's right can attach to the debtor's inventory and accounts receivable.").

123. *See* Duncan, *supra* note 96, at 7 n.29 ("[T]he trustee would be unable to show, as required by § 60(a)(2) of the Former Act, that a creditor on a simple contract could have acquired a 'superior' lien on the after-acquired collateral at any time subsequent to the original filing.").

124. *See* Countryman, *supra* note 6, at 792 (noting that the Ninth Circuit in *DuBay*, "by turning upside down the perfection provision of old section 60, which was aimed only at cases in which perfection was delayed, applied the provision to a case in which there was no delay in perfection and the perfection provision had no office to perform" (footnote omitted)); *cf.* H.R. REP. NO. 95-595, at 179 (1977) ("[T]he adoption of the Uniform Commercial Code radically altered the terminology of secured transactions, and the courts have applied the new terminology to the preference sections, which uses certain of the same words as the Uniform Commercial Code but in different senses and with different meanings."), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6139.

125. 11 U.S.C. § 547(e)(3) (2000).

126. *See id.* § 547(e)(2).

127. *See* Harrington, *supra* note 93, at 471 ("The limiting language [of § 547(e)(3)] in effect adopts the terminology of the Uniform Commercial Code and makes the term 'transfer' virtually synonymous with the term 'perfection' as understood under the Uniform Commercial Code."). The legislative history of the Code's preference provision describes the section as substantially modifying its predecessor under the Bankruptcy Act, with the result that "[i]t modernizes the preference provisions and brings them more into conformity with commercial practice and the Uniform Commercial Code." S. REP. NO. 95-989, at 87 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5873; H.R. REP. NO. 95-595, at 372, *reprinted in* 1978 U.S.C.C.A.N. 5963, 6328; *see also* Clark, *supra* note 101, at 161 ("Perhaps most important, the language of the new law [i.e., the Code] tracks better with the UCC because it was drawn with an eye squarely on the Article 9 security interest.").

128. *See* S. REP. NO. 95-989, at 89 ("This provision, more than any other in the section, overrules *DuBay* and *Grain Merchants* . . . ."), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5875; H.R. Rep. No. 95-595, at 374 (same), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6330; *see also* Clark, *supra* note 101, at 178 (observing that § 547(e)(3) "overrules decisions suggesting that *all* after-acquired-property clauses are insulated from preference attack"). Both the *DuBay* and *Grain Merchants of Ind., Inc.* courts saw protecting a floating lien from a trustee's preference attack as consistent with congressional intent to uphold the validity of the floating lien in bankruptcy. *See* DuBay v. Williams, 417 F.2d 1277, 1289 (9th Cir. 1969) ("Nothing in the legislative history of section 60a(2) suggests that Congress intended to permit a trustee to upset floating liens on accounts receivable . . . . If we read section 60a(2) the way the trustee asks us to do, we would defeat, not implement, Congress' intent . . . ."); Grain Merchs. of Ind., Inc. v.

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Congress's attempt to balance the competing interests of a floating lien creditor and unsecured creditors by situating the trustee in a position where he may attack a security interest in after-acquired collateral as preferential.[129]

* * *

One can see from the foregoing discussion that the evolution of a trustee's evidentiary burden has repeatedly involved coordinating two competing interests in bankruptcy—that is, (1) protecting a secured creditor's expectation that its security interest in the debtor's collateral will remain valid, and (2) increasing the distribution made to unsecured creditors.[130] Thus, in evaluating whether a judicial rule properly embraces our current concept of a preference we must ask whether the rule has created an arbitrary distinction that upsets the balance established by Congress. A departure from past practice—namely, evaluating the effect of a transfer on the petition date as *Palmer Clay Products Co.* instructs—can only be justified if such a rule will efficiently coordinate the interests of secured parties and unsecured creditors in such a way that their expectations are not compromised. Moreover, because avoidance of those transfers that upset the order of distribution established by federal bankruptcy law has always been the animating concern of the preference provision, a rule should prevail only if it does not undermine the ability of the trustee to restore the parties to their pre-transfer positions where appropriate. With these considerations in mind, this Article now considers the Ninth Circuit's decision in *In re Smith's Home Furnishings, Inc.*

Union Bank & Sav. Co., 408 F.2d 209, 215 (7th Cir. 1969) ("[I]t does not distort the Congressional purpose to conclude that the 'so far perfected' language of Section 60a(2) of the Bankruptcy Act was satisfied at the time of the . . . filing of the financing statements.").

129. *See* 5 COLLIER ON BANKRUPTCY, *supra* note 32, ¶ 547.04[5], at 547-71 (noting that, by virtue of § 547(e)(3), "virtually all security interests in after-acquired property will be considered transfers on account of antecedent debt, and will be avoidable by the trustee unless protected by section 547(c)(5) or one of the other preference exceptions"); Duncan, *supra* note 94, at 18 ("The impact of section 547(e)(3) . . . is dramatic . . . . [M]ost, if not all, security interests attaching to after-acquired collateral within ninety days of bankruptcy appear to be section 547(b) preferential transfers."); Harrington, *supra* note 93, at 472 ("The perfection of transfer test under section 547 calls into question the validity of a floating lien on all collateral acquired by the debtor during the ninety-day period prior to the filing of the bankruptcy petition."). The other part of this balance consists of the affirmative defense that the Code provides to a floating lien creditor. Under that defense, a trustee may not avoid security transfers to a floating lien creditor if the creditor establishes that its position did not improve during the preference period, as measured by the difference between (1) the collateral deficiency on the ninetieth day before bankruptcy and (2) the collateral deficiency on the day of bankruptcy. *See* 11 U.S.C. § 547(c)(5).

130. *Cf.* NAT'L BANKR. CONF., REPORT OF THE COMMITTEE ON COORDINATION OF THE BANKRUPTCY ACT AND THE UNIFORM COMMERCIAL CODE (1970) (noting that the basic objective of reworking section 60 of the Bankruptcy Act was a "resolution of the conflicting interests of secured and unsecured creditors in the disaster of bankruptcy which, although it might wholly satisfy neither group, might nevertheless be accepted by both groups as a reasonably satisfactory compromise"), *reprinted in* H.R. REP. NO. 95-595 app. at 204 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6164-65.

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B. In re Smith's Home Furnishings, Inc.

Originally a single store in Portland, Oregon in 1946, Smith's Home Furnishings, Inc. ("Smith's") had grown into a chain of nineteen retail stores located throughout the Pacific Northwest by the time it filed for bankruptcy on August 22, 1995. During the ten years preceding Smith's bankruptcy, TransAmerica Commercial Finance Corporation ("TCFC") helped Smith's finance its retail sale of electronic goods, appliances, and furniture.[131] In exchange for a first priority lien in certain merchandise purchased by Smith's and the proceeds thereof, TCFC extended credit to the retailer in the following manner: TCFC would grant a manufacturer approval to ship merchandise to Smith's.[132] Thereafter, Smith's would pay TCFC the wholesale price of any inventory it sold that had been obtained by virtue of TCFC's financing.[133]

These payments by Smith's to TCFC did not come directly from the sales proceeds of inventory subject to TCFC's floating line.[134] Rather, Smith's would pay TCFC from funds advanced by First Interstate Bank ("First Interstate"), Smith's revolving line-of-credit financier.[135] The retailer's cash management procedure with First Interstate required the bank to perform a daily sweep of Smith's accounts, thereby leaving them empty at the end of the day.[136] The accounts contained not only the deposits from the sales proceeds of TCFC's collateral, but also funds from other sources.[137] Provided Smith's had sufficient collateral the day following the cash sweep, First Interstate would extend it additional monies.[138] In this manner, Smith's maintained liquidity to pay operating expenses and creditors.[139]

From 1994 to August 1995, Smith's financial condition quickly deteriorated.[140] As a result of the substantial losses sustained by the retailer in 1994,[141] TCFC repeatedly reduced Smith's line of credit.[142] This period of distress was marked by TCFC's efforts to make Smith's pay down the debts it owed under their agreement.[143] In the ninety days preceding Smith's bankruptcy—the preference period—there were thirty-six payments totaling

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131. Batlan v. TransAmerica Commercial Fin. Corp. (*In re* Smith's Home Furnishings, Inc.), 265 F.3d 959, 961 (9th Cir. 2001).
132. *Id.*
133. *Id.*
134. *Id.*
135. *Id.*
136. *Id.*
137. *Id.*
138. *Id.*
139. *Id.*
140. *See* Batlan v. TransAmerica Commercial Fin. Corp., 237 B.R. 765, 768 (D. Or. 1999), *aff'd* 265 F.3d 959 (9th Cir. 2001).
141. By the time Smith's filed for bankruptcy seven months into the fiscal year, its pre-tax losses exceeded those of the previous fiscal year by $2.5 million. *See id.*
142. *See In re Smith's Home Furnishings, Inc.*, 265 F.3d at 961-62.
143. *Id.*

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more than $12 million from Smith's to TCFC.[144] At the time Smith's filed for Chapter 11 protection on August 22, 1995, it owed TCFC $10,728,809.96.[145]

Smith's operated under Chapter 11 slightly over a month before its attempt at reorganization failed.[146] The bankruptcy court converted the case to Chapter 7 and appointed Batlan as trustee.[147] During Smith's month in Chapter 11, TCFC recovered $1,568,659.47 from Smith's postpetition sales of TCFC's collateral.[148] After the case was converted, TCFC recovered with court approval an additional $9,254,351.11 by taking possession of and liquidating its collateral.[149] In total, the lender received a postpetition total of $10,823,010.58 on account of its prepetition claim.[150]

Other creditors, including those with over $1 million in priority unsecured claims, would not fare as well as TCFC.[151] Smith's estate was administratively insolvent, and Chapter 11 administrative expense claims would not be paid in full.[152] The Chapter 7 trustee, however, discovered the thirty-six payments Smith's made to TCFC within the preference period.[153] Convinced that the payments had a preferential effect, the trustee demanded that TCFC turn over the $12,842,438.96 for distribution to Smith's creditors.[154] After TCFC refused, the trustee commenced an adversary proceeding seeking a determination that the payments constituted preferential transfers and were therefore recoverable for the benefit of Smith's other creditors.[155] Only if the trustee prevailed in his motion would Smith's other creditors receive any payment on their prepetition claims.[156]

Before proceeding to trial, the parties agreed by stipulation that the thirty-six payments satisfied the first four elements of the Code's preference provision—that is, that the transfer was made (1) to the benefit of TCFC, (2) on account of an antecedent debt, (3) while Smith's was insolvent, and (4)

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144. *Id.*
145. *See id.*
146. Batlan v. TransAmerica Commercial Fin. Corp., 237 B.R. 765, 768 (D. Or. 1999).
147. *Id.*
148. *Id.*
149. *See id.*
150. *See In re Smith's Home Furnishings, Inc.*, 265 F.3d at 962.
151. At the time of Smith's bankruptcy filing, over $1 million in taxes, employee wages, and customer deposits remained unpaid. *See Batlan*, 237 B.R. at 768. Section 507 of the Code determines which claims have priority in distribution and the order in which they have priority. 11 U.S.C. § 507 (2000). Among those claims that have priority are certain prepetition tax, wage, and customer deposit claims. *Id.* § 507(a)(3), (a)(6), (a)(8).
152. *Batlan*, 237 B.R. at 769.
153. *In re Smith's Home Furnishings, Inc.*, 265 F.3d at 962.
154. *Id.*
155. *Id.*
156. On the trustee's appeal from the bankruptcy court, the district court noted that "no distributions [would] be made on account of any pre-petition claims, unless the trustee were to recover the disputed amounts paid to TCFC during the 90 day preference period." *Batlan*, 237 B.R. at 769. Because there were insufficient assets to satisfy Chapter 11 administrative expenses in full, no other priority or nonpriority unsecured creditors could receive payment on account of their claim by virtue of the priority ladder set forth in 11 U.S.C. § 726. *See* 11 U.S.C. § 726.

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within ninety days before bankruptcy.[157] Thus, the trustee would have to prove that the transfers to TCFC had enabled it to receive a greater amount than it would have received under a hypothetical Chapter 7 distribution.[158] In a pretrial conference, the bankruptcy judge alerted the parties that she was looking for evidence that TCFC's claim was not fully secured at the time of each of the thirty-six payments.[159] Despite such prompting, the trustee did not introduce any such evidence.[160] The absence of such a factual showing prevented the bankruptcy court from concluding that the disputed transfers had been preferences,[161] and it held that the trustee did not satisfy his burden of proof with respect to the greater amount test.[162]

The trustee appealed to the Ninth Circuit after his failed appeal to the district court,[163] but again to no avail. In affirming the bankruptcy court,[164] the court of appeals concluded that a trustee cannot rely on the "add-back method" to satisfy his burden of proof when the transferee has a floating lien.[165] Pursuant to the "add-back method," absolute transfers that are alleged to be preferences are added to the debt owed to the transferee on the petition date in order to determine the secured status of the transferee's claim for purposes of the greater amount test.[166] The majority observed that, when a creditor is paid from its own collateral, the trustee cannot use the add-back method to satisfy its burden of proof.[167] Given the manner in which collateral and debt fluctuate under a floating lien, the court of appeals deemed the add-back method inadequate to demonstrate that TCFC was not fully secured at the times of the payments; it held instead that the Code re-

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157. *In re Smith's Home Furnishings, Inc.*, 265 F.3d at 962; *Batlan*, 237 B.R. at 767, 769.
158. *See In re Smith's Home Furnishings, Inc.*, 265 F.3d at 962.
159. *Batlan*, 237 B.R. at 773 (quoting transcript of final pretrial conference).
160. *Id.* at 772 ("'The trustee has not presented evidence from which I could determine that defendant was undersecured when the payments were made.'" (emphasis omitted) (quoting bankruptcy court letter opinion)).
161. *Id. at* 773 (noting that the bankruptcy "court had no factual basis on which to rest a conclusion that any of the disputed transfers allowed TCFC to receive more than it would have received in a chapter 7 liquidation").
162. *Id.* at 772 ("'[The trustee] has not met his burden of proving that defendant was an undersecured creditor at the time it received one or more of the payments, and thus has not shown that the payment(s) allowed defendant to obtain more than it would have received in a Chapter 7 liquidation.'" (emphasis omitted) (quoting bankruptcy court letter opinion)).
163. *Id.* at 774.
164. Batlan v. TransAmerica Commercial Fin. Corp. (*In re* Smith's Home Furnishings, Inc.), 265 F.3d 259, 968 (9th Cir. 2001).
165. *Id.* at 964.
166. *Compare id.* at 963 (citing add-back method cases where trustee added absolute transfers to amount of debt owing to transferee on petition date in order to determine secured status of transferee's claim), *with id.* at 971 (Graber, J., dissenting) (observing that, in conducting preferential effect analysis pursuant to § 547(b)(5), "[t]he return of the payments to the estate potentially alters two quantities," amount of debt and amount of collateral securing debt, and that "[t]hose two quantities ultimately determine the extent to which a creditor is secured for purposes of § 547(b)(5)"). Pursuant to the plain language of § 547(b)(5)—namely, the hypothetical result that would have occurred if "the transfer had not been made," 11 U.S.C. § 547(b)(5)(B) (2000)—the greater amount test requires that the trustee add the amount of the payments to the amount of debt owed to the transferee on the petition date. *See supra* Part I.B.3. Accordingly, the "add-back method" referenced by the Ninth Circuit appears to be the equivalent of the greater amount test, but under a different name.
167. *In re Smith's Home Furnishings, Inc.*, 265 F.3d at 964, 967-68.

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quires the trustee to show that the floating lien creditor was undersecured at some point during the preference period.[168]

In reaching its holding on the trustee's burden of proof, the Ninth Circuit also considered an issue that neither the bankruptcy court nor the district court had addressed: whether the burden of proof rests on the trustee to establish that alleged preferential payments are made from a noncollateral source.[169] The trustee argued that, because TCFC had not established that the payments came from its collateral, he could satisfy his burden of proof by adding the amounts received by TCFC to the amount of its claim on the petition date.[170] The court of appeals dismissed the trustee's argument, holding that the greater amount test required the trustee to trace the funds from which the payments had been made.[171] The court emphasized that the Code places the burden of proof on a trustee to demonstrate the preferential effect of a transfer.[172] It concluded that the trustee could not resort to the add-back method to meet his burden under the greater amount test until he established that the alleged preferential payments to TCFC came from a noncollateral source.[173]

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168. *Id.* at 964 ("Under § 547(b)(5), the trustee must show that the amount of indebtedness under the floating lien was greater than the amount of collateral at some point during the 90-day period."); *id.* at 966 ("The trustee in this case never showed that TCFC was undersecured at any point during the 90-day period and the bankruptcy court determined that TCFC was fully secured as of the petition date. The trustee did not satisfy his burden.").

169. *See id.* at 966-68.

170. *See id.* at 966 ("The trustee contends that its use of the 'add-back' method is correct because TCFC has not shown that the source of the allegedly preferential payments was sales of TCFC's collateral."). It should be noted that the trustee improperly applied the greater amount test by adding the amount of payments received by TCFC to the amount it received from the postpetition sale of its collateral, *id.* at 963, although this fact did not affect the outcome of the case.

171. *Id.* at 967 ("[W]e hold that the language of the statute [§ 547(b)(5)] places the burden of demonstrating the source of such preferential payments squarely on the trustee.").

172. *Id.* at 966 (noting that, under the UCC, "there is a presumption against the creditor and in favor of the trustee. This is the opposite of a § 547(b) analysis where the burden of proof is on the trustee and the presumption is in favor of the creditor." (citation omitted)).

173. *Id.* at 967-68 ("[W]e are not prepared to release the trustee from his burden under § 547(b)(5) simply because the payments did not, demonstrably, come directly from sale of TCFC's collateral. It is up to the trustee to show that the payments did not come from TCFC's collateral before he can use the add-back method to satisfy his § 547(b)(5) burden." (citation omitted)). The court of appeals was not unanimous in its holding. The dissent took the view that the majority's decision violated the plain meaning of § 547(b)(5). *See id.* at 969 (Graber, J., dissenting) ("[B]y holding that TCFC was fully secured for purposes of § 547(b)(5) analysis, [the bankruptcy court and the majority] disregard the statutory directive to determine what the status of TCFC's claims would have been had the challenged payments not been made."). According to the dissent, a proper application of the greater amount test, which focuses on the hypothetical result absent the transfer, requires a trustee to add the amount of the challenged payments to the amount of the creditor's claim on the petition date. If the sum exceeds the value of the collateral securing the claim, the trustee will have established the preferential effect of the transfers, irrespective of the existence of a floating lien. *Id.* at 970. Of the view that Smith's made payments to TCFC from a noncollateral source, *id.* at 971-72, the dissent concluded that the trustee had satisfied his burden of proof under the greater amount test by establishing that (1) pursuant to the add-back method the amount of TCFC's claim exceeded the value of its collateral as of the petition date, and (2) no distributions would be made to unsecured creditors in the case, *id.* at 972.

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C. *The Incoherence of the Ninth Circuit's Rule*

1. *The Mandate of* Palmer Clay Products Co. *and Historical Imperative*

In assessing the logic of the Ninth Circuit's rule for establishing that transfers to a floating lien creditor have a preferential effect, the issue considered is whether requiring a trustee to provide direct evidence of the secured status of a floating lien creditor's claim at the times of transfers can be justified as part of a trustee's burden of proof under the greater amount test.[174] It cannot. The evidentiary concern that animated the Ninth Circuit—namely that the amounts of collateral and indebtedness constantly fluctuate under a floating lien—is irrelevant when calculating preferential effect. The greater amount test, as informed by the Supreme Court's decision in *Palmer Clay Products Co.*, focuses on a hypothetical Chapter 7 liquidation test *as of the petition date*.[175] The statute's directive thus precludes reference to the status of a creditor's claim other than on the petition date to establish preferential effect, whether that reference is to the date of transfer or some other point during the ninety-day preference period.

Even if the Ninth Circuit's rule did not contravene the generally accepted application of the greater amount test, there is no reason why, practically speaking, preferential effect cannot be determined as of the petition date when the amount of indebtedness and collateral change throughout the preference period. Both these amounts can fluctuate regardless of the type of lien held by the creditor—whether it is a floating lien that covers existing and after-acquired collateral, or whether it is a lien that covers a single item of collateral and nothing more. When the *amount* of indebtedness decreases or the *amount* of collateral increases, either an absolute transfer or security

174. Assuming that the majority was correct to conclude that the trustee did not demonstrate that the payments to TCFC were from a noncollateral source, a question arises regarding the applicability of the rule set forth in its opinion—that is, the rule that a trustee must establish evidence that a floating lien creditor was undersecured at some point during the preference period in order to satisfy his § 547(b)(5) burden. *Id.* at 964. From the court's statement that the add-back method would not satisfy the trustee's burden of proof when the payment came from a collateral source, *id.* at 963-64, one can draw the inference that the rule in *In re Smith's Home Furnishings, Inc.* would apply where payments came from a collateral source. *Compare id.* at 967-68 ("It is up to the trustee to show that the payments did not come from TCFC's collateral before he can use the add-back method to satisfy his § 547(b)(5) burden."), *with id.* at 963-64 (stating in section of opinion titled "*The add-back method does not satisfy the trustee's burden when the payments come from collateral secured by a floating lien*," that, "[u]nder § 547(b)(5), the trustee must show that the amount of indebtedness under the floating lien was greater than the amount of collateral at some point during the 90-day period"). But when a creditor is paid from its own collateral, such payment does not have a preferential effect. *See supra* text accompanying notes 62-64. It is thus impossible in such a scenario for a trustee to satisfy his burden of proof under the greater amount test. The rule proposed by the Ninth Circuit would be meaningless when the alleged preferential payments were made from a collateral source. Accordingly, this section will assay the logic of the rule in the context of payments made from a noncollateral source. Also, although the floating lien creditor in *In re Smith's Home Furnishings, Inc.* was oversecured on the petition date, *see supra* text accompanying notes 145-50, I assume that the Ninth Circuit's holding would apply in all floating lien cases irrespective of the transferee's secured status on the petition date.

175. *See supra* notes 31-35 and accompanying text.

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transfer by the debtor to the creditor affects such a change. If the amount of indebtedness has decreased, the debtor has made payment on part of the debt owed to the creditor (an absolute transfer).[176] If the amount of collateral has increased, the debtor has acquired new collateral and granted the creditor a security interest with respect thereto (a security transfer).[177] Since each discrete transfer can be analyzed for preferential effect under the greater amount test, a rule that deviates therefrom is unnecessary. While neither the greater amount test, as understood in light of *Palmer Clay Products Co.*, nor practical considerations with respect to the floating lien compel the conclusion reached by the Ninth Circuit, the question remains whether there is a historical basis for such a rule. Both the relaxation of the trustee's evidentiary burden over time and Congress's desire to ensure that a floating lien creditor not be shielded from a trustee's preference attack suggest that no such basis exists.

The fact that Congress went to great lengths to subject a creditor's floating lien to preference attack when it drafted the Code suggests that adopting a more complex evidentiary rule in that context cannot be justified. If Congress intended the floating lien to fall within the class of transfers subject to the Code's preference provision, then a rule that makes it more difficult to attack such a lien compromises that intent. Recall that the trustee can establish that a security transfer has a preferential effect under the greater amount test if the following two factors are satisfied: (1) The transferee has an allowed claim that is not oversecured by the amount of the transfer; and (2) there will be less than 100% distribution to the class of claims to which the

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176. If the amount of indebtedness has increased, the creditor has extended additional credit to the debtor. Because there is no transfer by the debtor in this instance, the extension of credit is not relevant for purposes of establishing preferential effect. It could, however, have relevance as an element of one of several creditor defenses to the trustee's preference attack. *See* 11 U.S.C. § 547(c)(1) (2000) (excepting from avoidance transfer intended to be contemporaneous exchange for new value and that is in fact substantially contemporaneous); *id.* § 547(c)(3) (excepting from avoidance enabling loans); *id.* § 547(c)(4) (permitting extension of new value to be applied against preceding preference to creditor); *id.* § 547(c)(5)(B) (establishing date upon which new value first given during the preference period as first point in improvement-in-position test for floating lien creditor).

177. By "amount of collateral," I mean "more" collateral, as opposed to an increase in the value of the original collateral securing the loan. Where mere appreciation of the value of the collateral results solely from market forces, no transfer will exist for the trustee to avoid. *See* Duncan, *supra* note 94, at 31. On the other hand, if the increase in value results from expenditures made by the debtor, the possibility exists that, for purposes of preference analysis, a court would find a transfer to have occurred. *See id.* at 31-33. If the amount of collateral has decreased, presumably the creditor has liquidated it and used the proceeds thereof to reduce its indebtedness through payment to the creditor. While the latter transaction (i.e., an absolute transfer) is a transfer subject to preference analysis, the former arguably is not because liquidation of collateral by itself does not constitute a transfer to a creditor. *See* U.C.C. § 9-315(a)(1) (1998) (providing that "a security interest . . . continues in collateral notwithstanding sale, lease, license, exchange, or other disposition thereof unless the secured party authorized the disposition free of the security interest"). *Contra* Carlson, *supra* note 13, at 255 (dismissing notion that "cash proceeds are the same thing as the original collateral," and arguing that security interest in collateral and security interest in proceeds therefrom represent two distinct transfers); *id.* at 248-50 (arguing that receipt by secured party of cash proceeds from debtor constitutes transfer on antecedent debt for purpose of § 547(b), and that such transfer may constitute voidable preference when collateral is not sold free and clear of creditor's security interest).

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transferee's unsecured claim belongs.[178] Unless there has been an objection to the transferee's claim that remains to be resolved, its allowed status will have been established when the trustee commences a preference action.[179] By virtue of the prima facie evidence of the amount of debt owed on the petition date to the transferee, the trustee would only have to present evidence of the amount of the security transfer in meeting his burden of proof with respect to the first factor. Under a rule that requires a showing of preferential effect at the time of transfer, however, the trustee would have to present evidence regarding both the amount of debt and the amount of collateral that existed prior to bankruptcy. In most instances, such a rule would exact a greater evidentiary burden on the trustee.[180] And where that burden could not be met (e.g., because of insufficient evidence), transfers that otherwise would have been deemed preferential under the greater amount test would escape the trustee's net. This, in turn, would upset the balance that Congress established between secured and unsecured creditors by ensuring that the floating lien would be subject to the trustee's preference attack.

In light of these statutory developments, it can be argued that a court should not construe the Code's preference provision in a way that heightens the evidentiary showing required by the trustee to satisfy his burden of proof on the preferential effect of a transfer. Recall that the Supreme Court noted in *Palmer Clay Products Co.* that proof of preferential effect at the time of transfer would be needlessly complicated and impractical.[181] A rule that requires such a showing thwarts Congress's efforts to ease the trustee's evidentiary burden. A more complex evidentiary showing than what Congress intended creates the potential for unsuccessful preference actions where the heightened burden cannot be met by the trustee. If preference law is to serve the equality principle effectively, a court must interpret the trustee's burden of proof in a manner that does not cabin the full statutory reach of that law. A rule that both compromises the equality principle and does so without historical or other compelling justification cannot be tolerated. The Ninth Circuit's rule fails to adhere to the relaxed evidentiary burden Congress has created for the trustee with regard to preferential effect.

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178. *See supra* Table 1.

179. *See infra* notes 201-03 and accompanying text. The statement presupposes that the transferee will have filed his claim before the trustee initiates a preference action. In a Chapter 7 or Chapter 13 case, a timely proof of claim is filed ninety days after the first date set for the meeting of creditors. FED. R. BANKR. P. 3002(c). In a Chapter 11 case, the court sets a bar date by which proofs of claim must be filed. *Id.* 3003(c)(3). The statement also makes the assumption that any valuation of collateral securing the transferee's claim, if requested by a party in interest, will have already taken place. *See id.* 3012 ("The court may determine the value of a claim secured by a lien on property in which the estate has an interest on motion of any party in interest and after a hearing on notice to the holder of the secured claim . . . .").

180. *See supra* note 35 and accompanying text.

181. *See id.*

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2. *The Applicability of State Law Presumptions*

The Ninth Circuit's decision also prompts an ancillary discussion of whether a court should give effect to state law presumptions against a creditor, notwithstanding the fact that the Code places the burden of proof on a trustee to establish the avoidability of a preferential transfer. Recall that the court of appeals held that, as part of the trustee's burden of proof to demonstrate that the alleged preferential payments came from a noncollateral source, the trustee was required to identify cash proceeds in a commingled account.[182] Undoubtedly, the trustee must establish that the source of an absolute transfer is from a noncollateral source.[183] Because a trustee bears the burden of proof with respect to preferential effect,[184] and because an absolute transfer will not be preferential if it comes from a collateral source,[185] it follows that the Code inevitably requires such a showing by the trustee. That burden, however, does not preclude a court from giving proper effect to a presumption under state law that helps the trustee establish his prima facie case, in the comparable way that the Code's presumption regarding the debtor's insolvency assists the trustee.[186]

A security interest attaches to cash proceeds of collateral that have been commingled with other property only to the extent that such proceeds are identifiable.[187] The plain language of the UCC squarely places the burden of tracing on the secured party.[188] The effect of this burden of proof is to create an implicit presumption in favor of the trustee with respect to the validity of the security interest. It is axiomatic that "[c]reditors' entitlements in bankruptcy arise . . . from the underlying substantive law creating the debtor's obligation, subject to any qualifying or contrary provisions of the Bankruptcy Code."[189] "Substantive law" not only includes any burden of proof that accompanies a claim,[190] but presumptions as well.[191] Accordingly,

182. *See supra* notes 169-71 and accompanying text.

183. *See* Batlan v. TransAmerica Commercial Fin. Corp. (*In re* Smith's Home Furnishings, Inc.), 265 F.3d 959, 967 (9th Cir. 2001) ("[W]e hold that the language of [§ 547(b)(5)] places the burden of demonstrating the source of such preferential payments squarely on the trustee.").

184. *See supra* note 24 and accompanying text.

185. *See supra* text accompanying note 77.

186. *See supra* notes 105-07 and accompanying text.

187. U.C.C. § 9-315(a)(2), (b)(2) (1998).

188. *Id.* § 9-315 (b)(2) (stating that commingled proceeds that are not goods are identifiable proceeds "to the extent that *the secured party* identifies the proceeds by a method of tracing" (emphasis added)).

189. Raleigh v. Ill. Dep't of Revenue, 530 U.S. 15, 20 (2000); *see also* IRS v. Levy (*In re* Landbank Equity Corp.), 973 F.2d 265, 270 (4th Cir. 1992) ("In resolving disputed claims against the bankruptcy estate, it is important to understand that the Bankruptcy Code, in most instances, while providing a forum and procedures for an expedient dispute resolution, does not endeavor to supplant the substantive law under which the claim against the estate (or for that matter any defenses, counterclaims, or other rights claimed by either party to the dispute) arose. It would appear that the substantive law regarding claims against the estate gives way only in those instances in which the internal goals of the bankruptcy system require alteration of externally created substantive rights, including (1) equality of distribution among creditors, (2) a fresh start for debtors, and (3) economical administration [of the bankruptcy system.]" (alteration in original) (citation and internal quotation marks omitted)).

190. *Raleigh*, 530 U.S. at 20-21.

191. Dick v. N.Y. Life Ins. Co., 359 U.S. 437, 446 (1959) ("Under the Erie rule, presumptions (and

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unless the Code alters the burden of proof with respect to a particular claim, it remains where state law imposes it.[192]

The Code clearly allocates the burden of proof between the trustee and creditor with respect to the avoidability of a preferential transfer.[193] In order to satisfy his burden of proof, the trustee must establish each element of a preference including that of preferential effect.[194] No reasonable basis exists to conclude that such a burden of proof would alter a presumption that exists in favor of the trustee under state law—in this case, the presumption that proceeds in a commingled account are unidentifiable, and thus not subject to a creditor's security interest, until the creditor has identified its proceeds through some method of tracing. In fact the Federal Rules of Evidence compel the opposite conclusion. Because a presumption does not alter the ultimate burden of proof between parties,[195] giving effect to the above-mentioned state law presumption would not upset the burden of proof scheme established by Congress in the Code's preference provision.[196] Moreover, the Federal Rules of Evidence make clear that presumptions controlled by state law apply in civil actions and proceedings.[197]

Because state law governs the status of a creditor's security interest in commingled cash proceeds—to wit, limiting the interest to the extent the creditor traces such proceeds to collateral that was subject to its security interest and thereby creating a presumption that such proceeds are noniden-

their effects) and burden of proof are 'substantive' . . . ." (footnote omitted)).

192. *See Raleigh*, 530 U.S. at 21-22 ("Congress of course may do what it likes with entitlements in bankruptcy, but there is no sign that Congress meant to alter the burdens of production and persuasion on tax claims. The Code in several places, to be sure, establishes particular burdens of proof. But the Code makes no provision for altering the burden on a tax claim, and its silence says that no change was intended." (citation omitted)).

193. *See supra* notes 24-25 and accompanying text.

194. *See supra* note 24 and accompanying text.

195. Rule 301 of the Federal Rules of Evidence provides:

> In all civil actions and proceedings not otherwise provided for by Act of Congress or by these rules, a presumption imposes on the party against whom it is directed the burden of going forward with evidence to rebut or meet the presumption, but does not shift to such party the burden of proof in the sense of the risk of nonpersuasion, which remains throughout the trial upon the party on whom it was originally cast.

FED. R. EVID. 301.

196. Fairness would also seem to dictate that the creditor is the party in the best position to trace its proceeds. *See* Ariz. Wholesale Supply Co. v. Itule (*In re* Gibson Prods. of Ariz.), 543 F.2d 652, 657 (9th Cir. 1976) (observing in context of Bankruptcy Act, "[w]e think that it is fair to place the burden on the creditor to identify his own proceeds and thus to defeat, in whole or in part, the trustee's claim of preference. The creditor is in a better position than the trustee to trace his proceeds."); *cf.* Waterman Steamship Corp. v. Aguiar (*In re* Waterman Steamship Corp.), 200 B.R. 770, 775 (Bankr. S.D.N.Y. 1996) (referring to the "general rule that when the true facts relating to a dispute are particularly within the knowledge of one party, then the burden of proving an issue lies with the knowledgeable party"). *Contra* Batlan v. TransAmerica Commercial Fin. Corp. (*In re* Smith's Home Furnishings, Inc.), 265 F.3d 959, 967 (9th Cir. 2001) ("One might argue that the creditor will be in a better position than the trustee to prove whether or not the alleged preferential payments came from the proceeds of the sale of its own collateral. On the other hand, in bankruptcy, it is the trustee who accedes to the debtor's books and records and has easier access and a better ability to divine the financial activities of the debtor in its last months of operation.").

197. FED. R. EVID. 302 ("In civil actions and proceedings, the effect of a presumption respecting a fact which is an element of a claim or defense as to which State law supplies the rule of decision is determined in accordance with State law.").

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tifiable until so traced—a trustee should be able to establish that payments to a creditor are from a noncollateral source merely by alleging that the payments came from commingled proceeds. As established by the proposed model for preferential effect, the source of payment with respect to an absolute transfer is an essential element of a trustee's preference claim under the greater amount test.[198] Accordingly, the presumption in favor of the trustee "supplies the rule of decision"[199] and should be readily available to him as he proceeds in establishing a prima facie case for preference avoidance. Failure to give effect to such a presumption gives rise to several problems that become evident when one examines the procedures established by the Code to resolve the amount, validity, and character of claims to property of a debtor's estate.[200]

A creditor generally will file a proof of claim after a debtor has filed for bankruptcy.[201] In the absence of objection by a party in interest, the claim will be "deemed allowed."[202] Moreover, if such claim is properly filed, it is prima facie evidence of the validity and the amount of the claim.[203] It is important to note that the presumptive validity afforded to a properly filed claim does not relieve the claimant of its ultimate burden of proof and persuasion: If an objecting party presents evidence that rebuts the prima facie effect given to the proof of claim, the burden shifts back to the claimant.[204]

A creditor who awaits payment until bankruptcy and subsequently files a proof of claim subjects himself to the burden of proof imposed by the Code. Assume that a creditor who files a claim alleges that it is secured by a security interest in proceeds in the debtor's bank accounts. Let us also assume that the debtor or trustee objects to the secured status of the claim on the basis that the proceeds are commingled with other funds that are subject to the claims of other creditors. The objection would be sufficient to rebut the prima facie evidence of the amount of the secured claim by virtue of the

198. *See supra* text accompanying note 77.

199. FED. R. EVID. 302.

200. When a debtor files for bankruptcy, an estate is created that includes "all legal or equitable interests of the debtor in property as of the commencement of the case." 11 U.S.C. § 541(a)(1) (2000).

201. The filing of a proof of claim is not mandatory. *See* 11 U.S.C. § 501(a) ("A creditor . . . *may* file a proof of claim." (emphasis added)); S. REP. NO. 95-989, at 61 (1978) (noting that § 501(a) "is permissive only, and does not require filing of a proof of claim by any creditor"), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5847; H.R. REP. NO. 95-595, at 351 (1977) (same), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6307. The failure to file a proof of claim, however, will either prohibit or impair a creditor's participation in the distribution of property from the debtor's estate. *See, e.g.*, 11 U.S.C. § 726(a) (establishing order of distribution in Chapter 7 case and limiting such distribution to claims that have been filed under § 501).

202. 11 U.S.C. § 502(a).

203. FED. R. BANKR. P. 3001(f).

204. Lundell v. Anchor Constr. Specialists, Inc. (*In re* Lundell), 223 F.3d 1035, 1039 (9th Cir. 2000); Agrecredit Corp. v. Harrison (*In re* Harrison), 987 F.2d 677, 680 (10th Cir. 1993); *In re* Allegheny Int'l, Inc., 954 F.2d 167, 174 (3d Cir. 1992); *see also* FED R. EVID. 301 (providing that presumption "does not shift to . . . party [against whom it is directed] the burden of proof in the sense of the risk of nonpersuasion, which remains throughout the trial upon the party on whom it was originally cast").

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tracing presumptions that limit such a claim.[205] The ultimate burden of proof and persuasion would then shift back to the creditor.

On the other hand, under a rule that ignores a state law presumption, a creditor whose claim is paid prior to bankruptcy from similar funds would circumvent any burden to trace the payments to its collateral. First, the creditor is exempted from the Code's claims procedure with respect to the prepetition payments received. In the absence of the payments, the creditor would have to have filed a claim to the proceeds and thus would have borne the ultimate burden of proof on his entitlement thereto. Second, in any preference action by the trustee to recover such payments, the trustee would bear the burden of proof to trace the payments to a noncollateral source.[206] Such a rule at a minimum gives a procedural advantage to the creditor who receives payment prior to bankruptcy by removing the burden that it would bear outside of bankruptcy. This, in turn, negates the concomitant presumption against the creditor and in favor of the trustee.

The possibility also exists that the rule will have a substantive effect on the creditor's claim to the proceeds insofar as it is outcome determinative. Assume that there is insufficient evidence to trace the payments to the creditor to their source. For the creditor who files the proof of claim that is met by objection, this lack of evidence will prevent the creditor from establishing the prima facie validity of the amount of his secured claim. For the creditor who is paid prior to bankruptcy, this lack of evidence will prevent the trustee from establishing the preferential effect of the payment since it will be deemed to have been made from the creditor's collateral. To disregard nonbankruptcy law burdens and presumptions in this scenario would result in the nonuniform treatment of the two creditors who shared the same legal entitlements prior to bankruptcy. Not only does such treatment give rise to uncertainty, but it also frustrates the equality principle, a directive that arguably extends to procedural considerations.[207] For these reasons, courts should give effect to nonbankruptcy law presumptions as the trustee sets forth his prima facie case of a preference.

CONCLUSION

This Article has presented a model of formalized rules for the greater amount test that is part of a larger and continuing process to ensure that preference law properly contours to the equality principle. Courts play a vital role in the success of this process. To this end, a court should not redefine burdens of proof in a manner that compromises the ability of the trustee to give full effect to the statutory reach of the Code's preference provision.

205. *See supra* notes 187-88 and accompanying text.

206. *See supra* notes 169-73 and accompanying text.

207. Whether for procedural or substantive advantage, the rule also creates an incentive for the creditor to obtain payment prior to bankruptcy. Given that this is the type of activity that preference law seeks to undo, *see supra* note 12 and accompanying text, it would indeed be perverse to read such a rule as part of the trustee's evidentiary burden in establishing preferential effect.

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Improper judicial interpretation of proof of preferential effect upsets the balance between secured and unsecured creditors that has evolved over decades and that is embodied, in part, in the evidentiary burden a trustee bears to establish preferential effect. As scholars continue to debate how this balance should be struck and how preference reform should take shape, an understanding of what constitutes adequate proof of preferential effect under the Code is essential.

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APPENDIX

This Appendix provides the analysis supporting the propositions discussed in the text regarding the preferential effect of transfers. Recall that § 547(b)(5) requires the comparison of two amounts: (1) the amount the transferee actually receives from the debtor, and (2) the amount the transferee would have received had the transfer not been made and had the transferee received payment in a hypothetical Chapter 7 case pursuant to provisions of the Code. A transfer will have had a preferential effect if the former exceeds the latter. The equations in the Appendix have been structured to reflect the difference between the two amounts and thereby demonstrate the preferential effect—if any—of the transfer. The notation to be used is as follows:

- z = preferential effect of transfer. For $z = 0$, the transfer does not have a preferential effect. For $z > 0$, the transfer has a preferential effect.
- y = amount of debt owed to transferee on petition date
- x = amount of transfer
- v = value of collateral securing y
- w = percent distribution to transferee's creditor class. The maximum and minimum percent distributions that could be made in any given case on account of a claim are respectively 100% and 0%. Accordingly, the measure for w is in the range $[0, 1]$.[208]
- s = amount of secured claim. If $y > v$, $s = v$; if $y \leq v$, $s = y$.
- s' = amount of hypothetical secured claim
- u = amount of unsecured claim. If $y > v$, $u = y - v$; if $y \leq v$, $u = 0$.
- u' = amount of hypothetical unsecured claim

208. For an explanation regarding treatment of w as a constant in the equations that follow, *see infra* Appendix, Part C.

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A. *Security Transfers*

The following equation expresses whether a prepetition security transfer has a preferential effect:

$$z = (s + uw) - (s' + u'w) \tag{1}$$

The value of the collateral securing the debt owed to the transferee will determine the status of the transferee's claim(s) pursuant to § 506(a). Thus, the values for s and u are determined by reference to y and v. For $y > v$, $s = v$ and $u = y - v$. For $y \leq v$, $s = y$ and $u = 0$. The amount of the collateral will be reduced by x in calculating the amount the transferee would have received in a hypothetical Chapter 7 case had the transfer not occurred. Thus, the values for s' and u' are determined by reference to v, y and x. For $y > v - x$, $s' = v - x$ and $u' = y - (v - x)$. For $y \leq v - x$, $s' = y$ and $u' = 0$.

1. Amount of Debt on Petition Date Is Less Than or Equal to Value of Collateral Less the Amount of Transfer. For $y \leq v - x < v$, $z = 0$. As a general matter, when on the petition date the amount of debt is less than the value of the collateral after the collateral has been reduced by the amount of the transfer, there is no preference. This principle can be demonstrated by substituting the values for s, s', u and u' into equation (1):

$$z = (y + 0w) - (y + 0w) \tag{2}$$

All terms cancel out, yielding $z = 0$. Accordingly, the trustee can never satisfy his burden of proof under § 547(b)(5) when the amount of debt on the petition date is less than the value of the collateral after it has been reduced by the amount of the transfer.

2. Amount of Debt on Petition Date Is Greater Than Value of Collateral Less the Amount of Transfer. For $y > v - x$, the transfer will have had one of three effects: (1) convert the status of the claim from undersecured to fully secured or oversecured; (2) convert the status of the claim from unsecured to undersecured; or (3) maintain the status of the claim as undersecured but with a reduction in the collateral deficiency.

a. Amount of Debt on Petition Date Is Less Than or Equal to Value of Collateral. When $v - x < y \leq v$, a prepetition security transfer will have had the effect of converting the status of the transferee's claim from undersecured to fully secured or oversecured. Substituting the values for s, s', u and u' under the above conditions into equation (1) yields:

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$$z = (y + 0w) - ((v - x) + (y - (v - x))w)$$

$$z = y - (v - x + (yw - vw + xw))$$

$$z = y - v + x - yw + vw - xw$$

$$z = (y - v + x)(1 - w) \tag{3}$$

For $w = 1, z = 0$. For $w < 1, z > 0$.

b. Amount of Debt on Petition Date Is Greater Than Value of Collateral. When $y > v > v - x$, a prepetition security transfer will have had the effect of either (1) converting the status from unsecured to undersecured or (2) reducing the collateral deficiency of an undersecured claim. Substituting the values for s, s', u and u' under the above conditions into equation (1) yields:

$$z = (v + (y - v)w) - ((v - x) + (y - (v - x))w)$$

$$z = (v + yw - vw) - (v - x + yw - vw + xw)$$

$$z = x - xw$$

$$z = x(1 - w) \tag{4}$$

Again, for $w = 1$, $z = 0$. Likewise, for $w < 1$, $z > 0$. Equations (3) and (4) demonstrate that the trustee satisfies his burden of proof under § 547(b)(5) with respect to a security transfer if he establishes that both (1) the amount of debt on the petition date is greater than the value of the collateral less the amount of the transfer, and (2) the percent distribution to the transferee's creditor class is less than 100%.

B. Absolute Transfers

The following analysis presupposes a transfer made from a noncollateral source.[209] The following equation expresses whether a prepetition absolute transfer has a preferential effect:

$$z = (x + s + uw) - (s' + u'w) \tag{5}$$

209. For the reasons discussed above, an absolute transfer of a creditor's own collateral does not have preferential effect. *See supra* notes 62-64 and accompanying text. If, however, the creditor has an interest in the collateral by virtue of a security transfer during the preference period, and that transfer is shown to be preferential, then the absolute transfer would be subject to preference attack. *See supra* note 64.

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Again, as with security transfers, the value of the collateral securing the debt owed to the transferee on the petition date will determine the status of the transferee's claim(s) pursuant to § 506(a). Values for s and u are thus defined by reference to y and v. For $y > v$, $s = v$ and $u = y - v$. For $y \leq v$, $s = y$ and $u = 0$. In calculating the actual amount the transferee received, the transferee is charged with the amount of the transfer in addition to any distributions to be made on its remaining claim(s). The amount of the debt owed to the transferee on the petition date will be increased by x when calculating the amount the transferee would have received in a hypothetical Chapter 7 case had the transfer not occurred. Thus, the values for s' and u' are determined by reference to v, y and x. For $y + x \leq v$, $s' = y + x$ and $u' = 0$. For $y + x > v$, $s' = v$ and $u' = (y + x) - v$.

1. Amount of Debt on Petition Date Plus Amount of Transfer Is Less Than or Equal to Value of Collateral. For $y < y + x \leq v$, $z = 0$. This can be demonstrated by substituting the values for s, s', u and u' into equation (5):

$$z = (x + y + 0w) - ((y + x) + 0w)$$

$$z = x + y - y - x \tag{6}$$

All terms cancel out, yielding $z = 0$. The trustee can never satisfy his burden of proof under § 547(b)(5) when the amount of debt on the petition date plus the amount of transfer is less than or equal to the value of the collateral securing the debt.

2. Amount of Debt on Petition Date Plus Amount of Transfer Is Greater Than Value of Collateral. For $y + x > v$, the transfer will have had one of three effects: (1) convert the status of the claim from undersecured to fully secured or oversecured; (2) maintain the status of the claim as undersecured, but with a reduction in the collateral deficiency; or (3) convert the status of the claim from unsecured to undersecured.

a. Amount of Debt on Petition Date Is Less Than or Equal to Value of Collateral. When $y \leq v < y + x$, a prepetition absolute transfer will have the effect of converting the status of the transferee's claim from undersecured to fully secured or oversecured. Substituting the values for s, s', u and u' under the above conditions into equation (5) yields:

$$z = (x + y + 0w) - (v + ((y + x) - v)w)$$

$$z = (x + y) - (v + yw + xw - vw)$$

$$z = x + y - v - yw - xw + vw$$

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$$z = (x + y - v)(1 - w) \qquad (7)$$

For $w = 1, z = 0$. For $w < 1, z > 0$.

b. Amount of Debt on Petition Date Is Greater Than Value of Collateral. When $y + x > y > v$, the absolute transfer will have the effect of either (1) reducing a prepetition collateral deficiency, or (2) converting the status of the claim from unsecured to undersecured. Substituting the values for s, s', u and u' under the above conditions into equation (5) yields:

$$z = (x + v + (y - v)w) - (v + ((y + x) - v)w)$$

$$z = (x + v + yw - vw) - (v + yw + xw - vw)$$

$$z = x - xw$$

$$z = x(1 - w) \qquad (8)$$

Again, for $w = 1, z = 0$. For $w < 1, z > 0$. Equations (7) and (8) demonstrate that the trustee satisfies his burden of proof under § 547(b)(5) with respect to an absolute transfer if he establishes that both (1) the amount of debt on the petition date plus the amount of the transfer is greater than the value of the collateral, and (2) the percent distribution to the transferee's creditor class is less than 100%.

C. *Percent Distribution to Creditor Class*

For purposes of efficiency, sections A and B of this Appendix assume that the percent distribution to the transferee's creditor class in the hypothetical case will be the same as in the actual case. It should be noted, however, that the value for w will change when calculating the amount the transferee would have received had the transfer not been made and had the transferee received payment in a hypothetical Chapter 7 case pursuant to the provisions of the Code. When calculating the amount the transferee would have received under the greater amount test, not only does the transferee's claim have to be adjusted by the amount of the transfer, but presumably a corresponding adjustment must be made to account for the increase in the assets available for distribution in the hypothetical case. Where a security transfer is targeted for avoidance, the property to which the security interest attached would be unencumbered in the hypothetical case. Where an absolute transfer is targeted for avoidance, the property transferred would have remained in the debtor's estate in the hypothetical case. Making either adjustment results in an increase in the percent distribution on account of claims in the creditor class to which the transferee belongs. But such fluctuation in no way alters the fact that the transfer in question was preferential in and of itself.

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Assume that, in the actual case, a equals the dollar amount of assets available for distribution to the creditor class, and c equals the dollar amount of all claims in the creditor class. The percent distribution in the actual case can be expressed as

$$w = \frac{a}{c}.$$

Also assume that the amount of assets for distribution in the actual case will be equally available in the hypothetical case.[210] After accounting for the return of transfer to the estate and adjusting the transferee's claim accordingly, the percent distribution in the hypothetical case can be expressed as

$$w' = \frac{a+x}{c+x}.$$

The following proof demonstrates that, where the amount of assets available for a pro rata distribution in the actual case are equally available in the hypothetical case, w' is always greater then w. For $w < 1$, $a < c$. Accordingly,

$$xa < xc$$

$$ac + xa < ac + xc$$

$$\frac{ac + xa}{c^2 + xc} < \frac{ac + xc}{c^2 + xc}$$

$$\frac{a(c+x)}{c(c+x)} < \frac{c(a+x)}{c(c+x)}$$

$$\frac{a}{c} < \frac{a+x}{c+x}$$

$$w < w' \qquad (9)$$

The percent distribution in the hypothetical case, however, will never equal 100% by virtue of accounting for the return of the transfer to the estate. Recall that for $w < 1$, $a < c$. Accordingly,

$$a + x < c + x$$

$$\frac{a+x}{c+x} < \frac{c+x}{c+x}$$

210. For a discussion regarding the situation where the amount of assets for distribution in the actual case will exceed those available in the hypothetical case, *see infra* note 211.

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$$\frac{a+x}{c+x} < 1$$

$$w' < 1 \qquad (10)$$

Where the assets available for pro rata distribution to the creditor class to which the transferee belongs remain equally available in the hypothetical Chapter 7 case, application of the greater amount test yields the following result with respect to the percent distribution on account of such claims as demonstrated by combining equations (9) and (10):

$$w < w' < 1 \qquad (11)$$

While the increased percent distribution in the hypothetical Chapter 7 case reduces the amount of the preference, it cannot increase w' to equal 1, and so ultimately does not prevent the trustee from establishing that the dividend on claims in the class to which the transferee's unsecured claim belongs is less than 100%. Thus the conclusions reached in this Article remain unaltered by treating w as a constant.[211]

211. The possibility also exists that w will be greater than w' if the amount of assets for distribution in the actual case will not be equally available in the hypothetical case. For example, given the added sources of funding in a Chapter 13 case in the forms of postpetition income and exempt property, *see* 11 U.S.C. § 1306(a) (2000) (expanding definition of property of estate to include property and earnings acquired postpetition); *id.* § 1322(a)(1) (requiring debtor to submit portion of postpetition income necessary to fund payment plan); *id.* § 1322(b)(8) (allowing debtor to provide for payment of claims from property of estate or property of debtor), it may be the case that the debtor proposes to pay the creditor class more than it could in a Chapter 7 case where unsecured claims would be paid from the proceeds of nonexempt property of the estate, *see id.* § 522(b) (authorizing individual debtor to exempt certain property of estate); *id.* § 704(1) (providing that, in Chapter 7 case, trustee shall "collect and reduce to money the property of the estate"); *id.* § 726(a) (setting forth order of distribution of property of estate in Chapter 7 case). Since the trustee must prove that the percent distribution is less than 100%, where $w' < w < 1$, treating w as a constant does not affect that analysis.

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