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WHY THE LACK OF INTEREST IN INTEREST? ANOTHER LOOK AT PREFERENCES AND SECURED CREDITORS

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I. Introduction

The Bankruptcy Code (sometimes referred to herein as the Code) disallows preferential payments made to creditors.[1] Bankruptcy preference law "ha[s] been hailed as 'the single greatest contribution of the Bankruptcy Act to the field of commercial law.'"[2] Preference law is "designed to prohibit insolvent debtors, on the eve of filing for bankruptcy, from paying off their debts held by 'preferred' creditors—those creditors whom the soon-to-be bankrupts wish to favor."[3] One purpose the preference provisions serve is that of "facilitat[ing] the prime bankruptcy policy of equality of distribution among creditors of the debtor."[4] The other purpose of preference law is to discourage creditors "from racing to the courthouse to dismember the debtor during his slide into bankruptcy."[5] This gives the debtor an opportunity to rescue his business and remove it from insolvency.[6]

The preference rule has five elements.[7] The payment must be (1) a transfer to a creditor, (2) for the benefit of an antecedent debt, (3) while the debtor was insolvent, (4) within ninety days of the filing of the petition (unless the creditor is an insider), and (5) the payment must "enable[] such creditor to receive more than such creditor would

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[1] *See* 11 U.S.C. § 547 (2012).

[2] Isaac Nutovic, *The Bankruptcy Preference Laws: Interpreting Code Sections 547(c)(2, 550(a)(1), and 546(a)(1)*, 41 BUS. LAW. 175, 175 (1985) (quoting MACLACHLAN, BANKRUPTCY 284 (1956)).

[3] In re Taylor, 599 F.3d 880, 888 (9th Cir. 2010).

[4] Union Bank v. Wolas, 502 U.S. 151, 161 (1991) (quoting H.R. REP. NO. 95-595, at 177–78 (1977), *reprinted in* 1978 U.S.C.C.N. 5963, 6138).

[5] *Union Bank*, 502 U.S. at 161 (quoting H.R. REP. NO. 95-595, at 177–78 (1977), *reprinted in* 1978 U.S.C.C.N. 5963, 6138).

[6] *See Union Bank*, 502 U.S. at 161.

[7] *See* 11 U.S.C. § 547(b) (2012).

receive" in a Chapter 7 liquidation.[8] This Article will analyze how the fifth and last element is applied, particularly with regard to fully secured creditors.

II. The Hypothetical Liquidation Test

The fifth element is sometimes called the "hypothetical liquidation test."[9] The full text of paragraph 547(b)(5) reads:

> [T]he trustee may avoid any transfer of an interest of the debtor in property . . .
>
> (5) that enables such creditor to receive more than such creditor would receive if—
>
> (A) the case were a case under chapter 7 of this title;
>
> (B) the transfer had not been made; and
>
> (C) such creditor received payment of such debt to the extent provided by the provisions of this title.[10]

A court must "construct a hypothetical chapter 7 case and determine what the creditor would have received if the case proceeded under chapter 7."[11]

A. Secured v. Unsecured Creditors

Generally, an unsecured creditor receiving a prepetition payment will have received more than in a chapter 7 liquidation.[12] This is true because, in a typical bankruptcy, the distribution made to unsecured creditors is less than 100% of their outstanding debt. Therefore, "*any* payment . . . will enable [an unsecured] creditor to receive more than" in a liquidation.[13]

The opposite rule holds true for secured creditors.[14] Prepetition payments to a fully secured creditor "generally 'will not be considered preferential because the creditor would not receive more than in a chapter 7 liquidation.'"[15] This rule seems appropriate because the underlying rationale for preference law "appl[ies] to a lesser degree to creditors with fully secured claims."[16] The fairness rationale does not apply in the case of a fully secured creditor because a fully secured creditor "is not required to share with other creditors on a pro rata basis" due to his security interest and there is less fear of a fully secured creditor "dismember[ing] a financially unsound debtor" because he is

[8] *See id.*

[9] *E.g.*, In re Friedman's Inc., 738 F.3d 547, 555–56 (3d Cir. 2013).

[10] 11 U.S.C. § 547(b)(5).

[11] In re LCO Enters., 12 F.3d 938, 941 (9th Cir. 1993).

[12] *See e.g.*, In re Powerine Oil Co., 59 F.3d 969, 972 (9th Cir. 1995).

[13] *Id.* This is because for the portion of debt that is paid prepetition, the unsecured creditor is being repaid at rate of 100%, as opposed to during a bankruptcy where unsecured creditors receive less than 100% for the entirety of their loan.

[14] *See id.*

[15] *Id.* (quoting 4 COLLIER ON BANKRUPTCY ¶ 547.08, at 547–45 (Lawrence P. King ed., 15th ed. 1995)).

[16] *See* In re Fuel Oil Supply & Terminaling, Inc., 837 F.2d 224, 227 (5th Cir. 1988).

certain of his payment to the extent of his security interest.[17]

B. Application of the Hypothetical Liquidation Test

When applying the hypothetical liquidation test, courts construct a counterfactual in which (1) there was a Chapter 7 liquidation proceeding, (2) the transfer was not made, and (3) the debtor's debt was discharged pursuant to the Bankruptcy Code.[18] The court then estimates how much the creditor would receive in the hypothetical case, which I will refer to as Scenario B, for the debt that was repaid with the allegedly preferential payment.[19] If this amount is lower than the amount of the prepetition payment, what we will call Scenario A, then the fifth prong of the preference analysis is satisfied.[20]

The hypothetical is not "conducted in a vacuum."[21] For example, when a creditor has a contract with the debtor, a court must estimate whether the contract would be assumed or rejected before concluding whether the prepetition payment benefitted the creditor.[22] When making this assessment, courts do not mechanically construct and apply a Chapter 7 liquidation model, but take into account the "actual facts of the case."[23] The hypothetical "assume[s] that [all] persons would act in a commercially reasonable and businesslike manner."[24]

III. Post-Petition Interest and the Hypothetical Liquidation Test: Why Secured Creditors Are Usually "Preferenced"

Although courts consider issues such as liquidation costs and contract assumption, they do not consider post-petition interest when performing the hypothetical liquidation test.[25] For example, consider the effect of post-petition interest[26] on a fully secured creditor with a $1 million debt, a $1 million security interest in the debtor, and the ability to receive a semi-annual interest rate of 4%. In Scenario A, he receives a $1 million cash payment on January 1 and the debtor files for bankruptcy on February 1 of the same year. Because the money is in the creditor's hands and not subject to the automatic stay, he will

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[17] *See id.*

[18] *See e.g.*, *In re Friedman's*, 738 F.3d at 556; In re Smith's Home Furnishings, Inc., 265 F.3d 959, 963 (9th Cir. 2001).

[19] *See In re Smith's Home Furnishings* 265 F.3d at 963.

[20] *See id.*

[21] *In re LCO*, 12 F.3d at 942.

[22] *See id.* at 941.

[23] *See id.* at 942–43.

[24] *See* In re ML & Assocs., Inc., 301 B.R. 195, 202 (Bankr. N.D. Tex. 2003).

[25] *See e.g.*, *In re LCO Enters.*, 12 F.3d at 942–44; *In re ML & Assocs.*, 301 B.R. at 202–03. *But see In re Fuel Oil Supply & Terminaling, Inc.*, 837 F.2d at 227 n.10 (noting that a fully secured creditor's incentive to obtain prepetition payments is merely "reduced" but still present, partly because he "forgoes earning interest on the retained collateral during bankruptcy").

[26] This argument applies only to the interest that could be earned after the filing. With regard to the interest between the preference and the filing though, there is no argument to say that there is a benefit. This is because the creditor's claim is accruing interest even in Scenario B, which means that on the day of the filing, there is no difference between Scenarios A and B. In both cases, he will have a right to the one million dollars with its accompanying interest for January 1st through February 1st.

employ this cash and receive a semi-annual interest rate of 4%. This will result in him earning forty thousand dollars every six months.

In Scenario B, a court would hypothesize either that the money was returned before February 1 or never paid to the creditor and the debtor then files for Chapter 7 on February 1. The creditor will then submit a claim for $1 million. However, even though he is fully secured, he will not receive interest until the conclusion of the Chapter 7 proceedings. In a liquidation proceeding with "extensive or complex litigation", the case can take years.[27] Supposing it takes half a year, he will receive $1 million in six months' time in Scenario B; in Scenario A, he will have $1.04 million.[28]

Another way of analyzing this is by comparing the present value of the payments in Scenario A and B. In Scenario A, the payment is today and the present value would therefore equal the payment, or one million dollars. In Scenario B, supposing the Chapter 7 takes six months, the present value of the million dollars is only $961,538.[29] Secured creditors seem to "flunk" the hypothetical liquidation test. This analysis runs counter to the legal dogma that secured creditors are not preferenced by prepetition payments.[30]

A. This Analysis Fits with the Statutory Text of Bankruptcy Code § 547(b)

The statutory language of the hypothetical liquidation test requires only that the prepetition payment "enable" the creditor "to receive more" than in hypothetical liquidation.[31] The term enable indicates that the analysis should encompass more than the prepetition payment itself. If Congress meant to limit the court's consideration to the actual payment, it could have stated "(5) that is greater than such creditor would receive if . . . " Additionally, the text of § 547 does not require that the benefit from the preference derive from the debtor themselves.[32]

B. This Analysis Follows the "Not Conducted in a Vacuum" and "Commercially Reasonable and Businesslike Manner" Approaches Taken by Courts

Preference case law also supports a contextual approach to constructing the hypothetical liquidation.[33] In *In re LCO Enterprises*,[34] the question of whether a creditor

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[27] *See* William J. Factor, *When is Chapter 7 the Best Option for Liquidating a Business?*, *in* CHAPTER 7 COMMERCIAL BANKRUPTCY STRATEGIES 91, 97 (2010), *available at* 2010 WL 895211 (noting that "it can take longer than a decade to administer a case involving extensive or complex litigation claims").

[28] This is equal to the one million dollars paid prepetition and an additional forty thousand dollars earned as interest over six months (1,000,000 x 1.04).

[29] This is equal to one million divided by 1.04.

[30] *See e.g.*, *In re Smith's*, 265 F.3d at 964.

[31] 11 U.S.C. § 547(b)(5).

[32] *See id.*

[33] A contextual approach, as opposed to a mechanical one, is crucial to this analysis. Most of the cases cited use this approach when constructing Scenario B (for example, by assessing if a contract will be assumed) while in this Essay's analysis the main effect is in Scenario A. Just as courts look beyond the petition date when constructing

benefitted from a prepetition payment depended on whether the creditor's contract with the debtor would be assumed or rejected in Scenario B.[35] If assumed, the debtor would be obligated to cure any default,[36] the creditor would therefore be paid in full, and the payment would not be a preference.[37] In the actual facts of that case, the contract was assumed but the question the court was considering was whether that fact should affect the hypothetical test.[38]

The court began its analysis by invoking the Supreme Court's ruling in *Palmer Clay Products Co. v. Brown*[39] that:

> The preferential effect of the payment must 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."[40]

This principle was applied in *In re Tenna Corp*.[41] to disregard a post-petition development of a super-priority in constructing the hypothetical liquidation.[42] Both cases seem to indicate that in a hypothetical liquidation, the court can only look at events as of the day of the filing.[43]

Despite this, the court in *In re LCO Enterprises* stressed that "the hypothetical liquidation . . . should not . . . be conducted in a vacuum,"[44] and that it "must be based on the actual facts of the case."[45] The court therefore ruled that, because the contract was assumed, there was a legal obligation on the debtor to repay the debt in full and therefore there was no benefit to the creditor due to the prepetition payment.[46]

Just as a court can consider post-petition events such as a contract assumption,[47] so too it can consider the length of a hypothetical liquidation in determining the amount that would be received in that proceeding, relative to what a prepetition payment "enabled" a creditor to receive.

Scenario B, this analysis looks at the length of the proceedings after the petition date to either discount the payment in Scenario B or to calculate interest that can be earned in Scenario A.

[34] 12 F.3d 938 (9th Cir. 1993).
[35] *See id.* at 941.
[36] *See id.* (citing 11 U.S.C. § 365(b)).
[37] *See In re LCO Enters.*, 12 F.3d at 941.
[38] *See id.* at 942.
[39] 297 U.S. 227 (1936).
[40] *In re LCO Enters.*, 12 F.3d at 942 (quoting *Palmer Clay*, 297 U.S. at 229).
[41] 801 F.2d 819 (6th Cir. 1986).
[42] *See id.* at 823.
[43] *See In re LCO*, 12 F.3d at 942.
[44] *See id.* (quoting In re LCO Enters., 137 B.R. 955, 959 (B.A.P. 9th Cir. 1992)).
[45] *See In re LCO*, 12 F.3d at 940.
[46] *See id.* at 942.
[47] *See id.*

C. Applying Preference Law to Payments to Secured Creditors Fits with the Rationale for Preference Law

Allowing secured creditors to receive prepetition payments and ignoring the practical benefits accruing to them due to the time value of money runs counter to the policy rationales underlying preference law. These reasons are described in the legislative history of section 547:

> The purpose of the preference section is two-fold. First, by permitting the trustee to avoid prebankruptcy transfers that occur within a short period before bankruptcy, creditors are discouraged from racing to the courthouse to dismember the debtor during his slide into bankruptcy. The protection thus afforded the debtor often enables him to work his way out of a difficult financial situation through cooperation with all of his creditors. Second, and more important, the preference provisions facilitate the prime bankruptcy policy of equality of distribution among creditors of the debtor. Any creditor that received a greater payment than others of his class is required to disgorge so that all may share equally.[48]

Payments to secured creditors should be avoided pursuant to both of these reasons.

1. The dismemberment fear

As noted in *In re Fuel Oil Supply & Terminaling, Inc.*, there is an incentive, albeit reduced, even for secured creditors to obtain prepetition payments due to the time value of money.[49] If a bank has knowledge that a debtor is having financial difficulties and may need to enter bankruptcy, there is a very real incentive for them to try to force the debtor to use whatever cash is available to pay their debts. Their alternative, in the real world, is to wait for the conclusion of a Chapter 11 proceeding. Although Congress is attempting to shorten the duration of Chapter 11 cases by limiting the period of exclusivity for debtors to file plans of reorganization,[50] even a secured creditor must fear that his money will be tied up for the duration of the proceedings. If there are many creditors, the case can take a long time.[51] Thus, the first rationale for preferences applies to secured creditors as well.

2. The fairness concern

Additionally, fairness should dictate that payments to secured creditors are avoidable preferences. First, as the Ninth Circuit formulated the fairness argument, preference law was meant to "prohibit insolvent debtors, on the eve of filing for bankruptcy, from paying off their debts held by 'preferred' creditors—those creditors

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[48] H.R. REP. NO. 95-595, at 177–78 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6138.

[49] 837 F.2d at 227 n.10.

[50] *See* Bankruptcy Abuse Protection and Consumer Protection Act of 2005 § 411, 11 U.S.C. § 1121(d)(2) (2012).

[51] *See* M. Todd Henderson, *Paying CEOs in Bankruptcy: Executive Compensation When Agency Costs are Low*, 101 NW. U. L. REV. 1543, 1607 n.327 ("The average time a firm spends in Chapter 11 is about 18 months.").

whom the soon-to-be bankrupts wish to favor."[52] Given the interest of a creditor in avoiding having his money tied up in a bankruptcy, this consideration is very real even for secured creditors. Supposing a debtor has several secured creditors with claims of one million dollars, and the debtor has only one million in cash, he can favor a "preferred" creditor by paying them the cash and allowing them to avoid waiting out the ensuing bankruptcy.

Additionally, there is a fairness concern that prepetition payment to a secured creditor will result in less money for the other creditors, secured or otherwise. Allowing the debtor to keep its cash means that the debtor, and not the secured creditor, will capture the benefit of the time value of money. This value can be obtained either by lending out the money, or, as is more likely, if the debtor needs the cash to operate in bankruptcy, keeping its cash allows the debtor to avoid obtaining expensive debtor-in-possession financing. Thus, avoiding prepetition payments for secured creditors "facilitate[s] the prime bankruptcy policy of equality of distribution among creditors of the debtor."[53]

IV. Conclusion

Current case law clearly holds that payments made to a secured creditor are not voidable because the creditor was guaranteed to be repaid that amount, due to his security. However, this does not account for the real world practicality that receiving a prepetition payment is greatly beneficial to the secured creditor as it allows him to receive interest on that money during the pendency of the Chapter 11 proceedings.

The statutory text seems to allow for this consideration, as it states that a prepetition payment need only "enable" the creditor to receive more. Additionally, current bankruptcy doctrine has other instances where courts create a hypothetical scenario (such as would need to be created to account for post-petition interest) in analyzing if a creditor is better off.[54]

The underlying preference law rationale militates for such a rule as well. Allowing secured creditors to keep prepetition payments will lead to such creditors rushing the debtor and actually causing a filing, which is precisely the result preference law was meant to prevent.

[52] *In re Taylor*, 599 F.3d at 888.
[53] H.R. REP. NO. 95-595, at 177–78 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6138.
[54] See *supra*, note 18.