FALL 2021

STETSON LAW REVIEW FORUM

When the Sum of the Parts are More than the Whole: How Fully Secured Creditors Can Be Preferred in Bankruptcy

*Theresa J. Pulley Radwan**

The bankruptcy system seeks to provide debtors with relief from overwhelming debt, while ensuring a fair and equitable distribution to creditors.[1] Though the filing of a bankruptcy petition stays most debt collection efforts and repayment outside of the bankruptcy system,[2] payments made prior to the bankruptcy filing may diminish funds available to distribute to creditors during the bankruptcy case. In order to prevent pre-petition transfers from impacting post-petition distribution within the bankruptcy system, the Bankruptcy Code provides the bankruptcy trustee with the power to avoid various pre-petition transfers[3] and to recover those transfers from the recipient.[4] With regard to one of those potential transfers—preferential transfers—courts regularly find that transfers to fully secured creditors cannot be avoided.[5] However, this conventional wisdom fails to consider how other sections of the Code that allow such creditors to recover additional payments in bankruptcy causes a benefit to those creditors at the expense of others. This article seeks to resolve the

 Professor of Law and Transitional Business Administrator, Stetson University College of Law.

[1] I.R.S. v. Loungo (*In re* Luongo), 259 F.3d 323, 330 (5th Cir. 2001) ("The bankruptcy court's responsibility in administering the estate is not only to achieve a fair and equitable distribution of assets to the creditors, but also to 'relieve the honest debtor from the weight of oppressive indebtedness and permit him to start afresh.'") (citing Local Loan v. Hunt, 292 U.S. 234, 244 (1934)).

[2] 11 U.S.C. § 362(a).

[3] 11 U.S.C. §§ 544, 545, 547, 548, 553.

[4] The authority to avoid transfers under the sections listed above triggers the trustee's right to recover the avoided transfer under 11 U.S.C. § 550(a) which states "to the extent that a transfer is avoided . . . the trustee may recover, for the benefit of the estate, the property transferred or, if the court so orders, the value of such property, from [the initial or subsequent transferees]." 11 U.S.C. § 550(a).

[5] Bruinsma v. Citizens Banking Corp. (*In re* Fleming), 226 B.R. 3, 7 (Bankr. W.D. Mich. 1998) ("It is well-settled that payments made to fully-secured or oversecured creditors are not avoidable preferences 'since the creditor would receive payment up to the full value of his collateral in a Chapter 7 liquidation.'") (citing Ray v. City Bank & Trust Co., 899 F.2d 1490, 1493 (6th Cir. 1990)).

lack of congruity between these sections to protect the purposes behind recovery of preferential pre-petition transfers.

I. PREFERENTIAL TRANSFERS

Section 547 of the Code grants the bankruptcy trustee[6] the ability to seek the return of preferential transfers.[7] The recovery of such transfers serves to eliminate the value creditors could receive by racing to grab assets from the debtor during the debtor's decline into bankruptcy. Preventing creditors from benefitting from such a pre-petition taking ensures that similarly situated creditors receive an equitable distribution from the bankruptcy estate.[8]

To establish the existence of a preferential transfer, the bankruptcy trustee has the burden of establishing that:

(1) "an interest of the debtor in property" has been transferred to a creditor,[9]
(2) to satisfy a pre-existing debt,
(3) at a time when the debtor was insolvent,[10]

[6] In a chapter 11 bankruptcy case, the debtor-in-possession takes on this power normally reserved to the bankruptcy trustee. 11 U.S.C. § 1107. Most chapter 11 bankruptcy cases do not involve a trustee, though one can be appointed even in a chapter 11 case in the event of fraud, mismanagement, or other listed basis, or if appointment of a trustee serves the best interests of the estate and creditors. 11 U.S.C. § 1104(a).

[7] 11 U.S.C. § 547(b).

[8] *In re* Rocor Int'l, Inc., 380 B.R. 567 (10th Cir. BAP 2007) ("The purpose of the preference section is twofold. First, . . . creditors are discouraged from racing to the courthouse to dismember the debtor during his slide into bankruptcy. . . . Second, and more important, the preference provision facilitates 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.") (citing *In re* Schwinn Bicycle Co., 200 B.R. 980, 993 (Bankr. N.D. Ill. 1996)) (quoting H.R. REP. NO. 95-595, at 176, *reprinted in* 1978 U.S.C.C.A.N. 5787, 6138 WL 9628 (Westlaw) (emphasis added by *Rocor* court)).

[9] A transfer can be made directly to the creditor or for the benefit of a creditor. 11 U.S.C. § 547(b)(1).

[10] While the trustee has the burden of establishing most elements of a preferential transfer, for the purposes of preferential transfer recovery, debtors are rebuttably presumed to be insolvent for the 90 days pre-petition. 11 U.S.C. § 547(f). The burden of establishing solvency during that 90-day period is on the transferee seeking to prevent recovery of the allegedly preferential transfer. Devan v. CIT Group (*In re* Merry-Go-Round Enter., Inc.), 229 B.R. 337, 341 (Bankr. D. Md. 1999).

(4) during the relevant preference reachback period,[11] and
(5) that allows the creditor to benefit financially compared to what would have been received without the transfer.[12]

For example, if the debtor owed a creditor a significant sum pre-petition and, faced with the threat of a lawsuit, granted the creditor a security interest in collateral to avoid the litigation shortly before filing for bankruptcy, a preferential transfer likely occurred because the debtor transferred a security interest in property to the creditor that puts the creditor in a better position in the subsequent bankruptcy proceeding as a result of the transfer.

In interpreting the final element—whether the transfer allowed the creditor to receive more than otherwise would be received absent the transfer—courts have generally determined that a "fully secured" creditor cannot receive a preferential transfer due to a lack of financial benefit from the transfer. [13] This occurs because secured creditors generally receive full payment in bankruptcy, either by being paid in the bankruptcy proceeding or by receiving the collateral securing the lien.[14] Since the creditor is paid in full either way, the pre-petition transfer caused no financial gain.

Consider, for example, a situation in which Corporation borrows money from a Bank, secured by a first-priority lien on all of Corporation's inventory and equipment. Throughout the preference period (typically 90 days pre-petition),[15] the value of Corporation's inventory and equipment totaled $1 million, while the amount due to the Bank never exceeded $950,000. A few weeks prior to Corporation's chapter 11 bankruptcy filing, Corporation made a payment to the Bank of $150,000, reducing the debt owed to the Bank to $800,000. For simplicity, assume that the $150,000 payment depleted Corporation's cash reserves, leaving its inventory and equipment

[11] The reachback period is 90 days in most cases but can extend back as far as a year if the recipient of the transfer qualifies as an insider. 11 U.S.C. § 547(b)(4). An insider includes, *inter alia*, relatives of the debtor, businesses owned or controlled by the debtor, officers and directors of the debtor, and partners of the debtor. 11 U.S.C. § 101(31).

[12] 11 U.S.C. § 547(c)(4).

[13] *See, e.g.*, *In re* Jackson, No. 12–10757–JDW, 2012 WL 6623497, at *2 (Bankr. M.D. Ga. Dec. 18, 2012) (determining creditor's fully secured status).

[14] Schwinn Plan Comm. v. Transamerica Ins. Fin. Corp. (*In re* Schwinn Bicycle Co.), 200 B.R. 980, 988 (Bankr. N.D. Ill. 1996) ("However, a creditor that receives payment attributable to a secured claim is not usually 'preferred' because secured creditors generally receive 100% of the value of their collateral upon distribution in a Chapter 7 case.") (citations omitted).

[15] 11 U.S.C. § 547(b)(4).

as its only assets, and that all other creditors are unsecured. Section 547(b)(5) requires a comparison of the amount that the creditor received with the transfer and the amount that the creditor would receive in a hypothetical chapter 7 bankruptcy had no transfer occurred, sometimes known as the "greater amount" test.[16] If the pre-petition transfer allows the creditor to recover more than the creditor could recover without said transfer in bankruptcy, the creditor (assuming all other elements are met) received a preferential transfer. But if the creditor did not financially benefit from the pre-petition transfer, no preferential transfer occurred. In this situation, with the pre-petition transfer, the Bank received the $150,000 cash pre-petition transfer and enters the bankruptcy case with a claim for the remaining $800,000 owed. In the bankruptcy case, the Bank will receive all $800,000 owed to it because a secured creditor must be paid in full or retain a lien on the collateral to ensure future payment,[17] for a total payout of $950,000. Without the pre-petition transfer in a hypothetical chapter 7, the Bank would instead hold a $950,000 claim secured by $1 million of collateral and would be paid all $950,000 in the bankruptcy or retain its lien on the assets for eventual payment of $950,000.[18]

Thus, regardless of the scenario, the Bank would receive full payment of the amount due or retain its lien on the collateral to ensure that it will eventually receive the entire amount due. That means that § 547(b)(5)'s requirements cannot be met with regard to this fully secured creditor because it receives full payment—whether in the bankruptcy or by retention of collateral that will allow it to recover fully outside of the bankruptcy context. And either way, $200,000 remains to pay other creditors. With the pre-petition transfer, $200,000 of the value of the inventory and equipment remains with the estate because it is not needed to pay the Bank. Without the

[16] Smith's Home Furnishings, Inc. v. TransAmerica Com. Fin. Corp., 265 F.3d 959, 963 (9th Cir. 2001) ("[T]he trustee must show that the creditor received a greater amount than it would have if the transfer had not been made and there had been a hypothetical chapter 7 liquidation as of the petition date.").

[17] *See* 11 U.S.C. § 1129(b)(2) (explaining the confirmation of a plan generally requires, unless secured creditors otherwise agree, that secured creditors' liens continue and that the creditor receive full payment of the claim, or that the creditor's lien continues on the proceeds of any sale of the collateral).

[18] GERALD L. BLANCHARD & RODNEY A. MORRIS, ELEMENTS OF PREFERENCE, 2 Prob. Loan Workouts §13:50 (Thompson Reuters 2020–21 ed.) ("This requirement will generally insulate payments made on a secured debt because the secured creditor would be entitled to return of its collateral or payment in full in a Chapter 7 case.").

transfer, $50,000 of the value of the inventory and equipment plus the $150,000 cash that was never paid out remains with the estate.

Because creditors receive the value of their entire secured claim in bankruptcy cases, caselaw generally recognizes the conventional wisdom that a fully secured creditor cannot receive a preferential transfer.[19] When issues arise regarding fully secured creditors, they frequently involve whether the creditor qualifies as a fully secured creditor, or at what point in time a creditor must be fully secured to take advantage of this principle.[20] But the conventional wisdom ignores the reality that a fully secured creditor may benefit financially by a pre-petition transfer when considered in conjunction with another section of the Code.

II. ADDITIONAL PAYMENTS TO SECURED CREDITORS

Some secured creditors receive payment in excess of their pre-petition claims in a bankruptcy case. Section 506(b) of the Code allows oversecured creditors to accrue post-petition interest and attorneys' fees, if provided for by contract, to the extent of their "equity cushion."[21] Unsecured (or undersecured) creditors, by contrast,

[19] *In re* Smith's Home Furnishings, Inc., 265 F.3d at 964 ("Pre-petition transfers to a creditor that is fully secured on the petition date are generally not preferential because the secured creditor is entitled to 100 percent of its claims. . . . [t]his is not a hard and fast rule.") (citing LCO Enters. v. Walsh, 12 F.3d 938, 941 (9th Cir. 1993)).

[20] For example, cases consider situations in which the pre-petition transfer causes an undersecured creditor to become fully secured, *see e.g.*, Porter v. Yukon Nat'l Bank, 866 F.2d 355, 359 (10th Cir. 1989), or where a fully secured creditor becomes undersecured by time of bankruptcy filing. *See e.g.*, Estate of Sufolla, Inc. v. U.S. Nat. Bank of Or., 2 F.3d 977, 986 (9th Cir. 1993). *See also* Rocor Int'l, Inc. v. UPAC, 380 B.R. 567, 576 (10th Cir. 2007) ("[T]he determinative issue here is at what *time* a secured creditor's status, as either a fully secured or undersecured creditor, should be assessed."); Schwinn Bicycle Co. v. TransAmerica Ins. Fin. Corp, 200 B.R. 980, 996 (Bankr. N.D. Ill. 1996) (holding that a secured creditor must be fully secured throughout preference period to avoid preferential transfer recovery).

[21] 11 U.S.C. § 506(b) ("To the extent that an allowed secured claim is secured by property the value of which, after any recovery under subsection (c) of this section, is greater than the amount of such claim, there shall be allowed to the holder of such claim, interest on such claim, and any reasonable fees, costs, or charges provided for under the agreement or State statute under which such claim arose."); 2C Bankr. Service L. Ed, *Equity Cushion—Illustrative Particular Applications* § 20:308 (July 2021 Update).

may not accrue additional interest post-petition.[22] Thus, if the value of the collateral securing a claim exceeds the debt owed to the secured creditor, that creditor may add to its secured pre-petition claim after the bankruptcy filing.[23] Courts do deal with several issues regarding these payments. For example, issues arise concerning when to determine the existence of, or amount of, the equity cushion for the purposes of determining the ability of the creditor to accrue post-petition interest and fees. Issues also arise regarding the appropriate rate of interest to allow the creditor to charge against the equity cushion.[24] But no doubt exists that a truly oversecured creditor enjoys the ability to claim post-petition, contractually-permitted interest and fees.

III. BENEFITTING A FULLY SECURED CREDITOR BY A PRE-PETITION TRANSFER

While interpretations of Section 547(b)(5) largely focus on the reality that fully secured creditors receive complete payment of their claims even in a bankruptcy case, those interpretations fail to recognize the possibility that a pre-petition transfer enhances the potential recovery of some oversecured creditors—and that such enhancement comes at the expense of remaining creditors. To understand this possibility, reconsider the example outlined above. In that situation, Corporation owed the Bank $950,000, secured by $1 million of inventory and equipment. Assume that the loan agreement between the Bank and Corporation provides for (1) interest that accrues on a monthly basis and (2) attorney's fees if the Bank must litigate any of its rights under the loan agreement. Further, assume that during the year post-petition, an additional $50,000 in interest accrued on the loan and that the Bank incurred $30,000 in attorneys' fees defending itself from an alleged preferential transfer action and ensuring protection of its secured claim in the bankruptcy case.

[22] 11 U.S.C. § 502(b)(2) (denying claims for "unmatured interest" as of the petition date). Some debate exists as to Code interpretation on attorneys' fees for unsecured creditors. *In re* Elec. Mach. Enters., Inc., 371 B.R. 549, 549–50 (Bankr. M.D. Fla. 2007) ("The majority of courts have held that an unsecured creditor is not entitled to collect post-petition attorneys' fees, costs, and other similar charges—even if there is an underlying contractual right to do so."); *cf*. *In re* Pioneer Carriers, LLC, 581 B.R. 809, 820–21 (Bankr. S.D. Tex. 2018) (declining to find absolute prohibition of post-petition attorney's fees for unsecured creditor).

[23] United Savs. Assn of Tex. v. Timbers of Inwood Forest Assocs., Ltd., 484 U.S. 365, 372–73 (1988).

[24] *See, e.g.*, *In re* SW Boston Hotel Venture, LLC, 748 F.3d 393, 405 (1st Cir. 2014) (using a flexible approach to determine the date of oversecurity for the purpose of accruing post-petition interest and starting with contract rate of interest and adjusting it for purposes of determining appropriate rate of interest).

As a result, the Bank incurred $80,000 of post-petition claims that would be disallowed for most creditors, but which are allowed for an oversecured creditor under Section 506(b). Finally, assume that in the bankruptcy case, unsecured claims will be paid twenty cents on the dollar.

With that framework, reconsider the comparison required by Section 547(b)(5)—a comparison of what the creditor receives *with* the preferential transfer versus what the creditor would receive in a hypothetical chapter 7 bankruptcy case *without* the transfer. With the transfer, the Bank received $150,000 pre-petition that allows the Bank to enter the bankruptcy case as a $200,000 oversecured creditor because the now-$800,000 claim is secured by $1 million in collateral. As a result, the Bank would be entitled to add the entire $80,000 of post-petition interest and fees to its claim, for a total claim of $880,000 secured by $1 million of collateral (with the potential for an additional $120,000 more in interest and fees to come during the pendency of the bankruptcy case). As a result, the Bank will receive a total of $1,030,000 ($150,000 pre-petition and $880,000 in the bankruptcy case or outside of the bankruptcy system through traditional secured-creditor remedies against the collateral). The remaining $120,000 of collateral value remains available for the trustee's use in paying other creditors, unless the Bank accrues even more interest and fees post-petition.

On the other hand, what result ensues if the Bank did not receive the pre-petition transfer and the debtor filed for chapter 7? The Bank enters bankruptcy as a creditor with a $950,000 claim secured by $1 million of collateral. That allows the Bank to use its $50,000 equity cushion to accrue post-petition interest and fees. But, while the Bank incurs $80,000 in interest and fees, it will only be able to enjoy secured status as to $50,000 of those interest and fees; the remaining $30,000 of interest and fees are unsecured and cannot be claimed by the Bank. The Bank would receive a total of $1,000,000, either through payment or by retention of its lien to cover the $950,000 pre-petition and $50,000 post-petition allowed claims. Thus, by receipt of the pre-petition $150,000 payment, the Bank benefited to the extent of $30,000.

Recall that one of the policy reasons for undoing preferential transfers is to ensure that some creditors do not take at the expense of other creditors. Unfortunately, with the pre-petition transfer, the Bank takes its extra $30,000 in value from the estate and, thus, from other creditors. Without the pre-petition transfer, the $1 million in inventory and equipment would become property of the

estate,[25] eligible to pay the claims of all creditors. While all $1 million would go to the Bank if the Bank has $50,000 (or more) of post-petition interest and fees, the $150,000 cash that would otherwise have been paid to the Bank will remain with the Corporation, available to pay other claims. But with the pre-petition transfer, that $150,000 cash is no longer available to pay other claims and, since the Bank will use $880,000 of the inventory and equipment to satisfy its claims, only $120,000 of value remains to pay other claims—a net loss of $30,000 available to pay other claims. The gain for the Bank comes at the expense of the bankruptcy estate and, ultimately, other creditors.

IV. HARMONIZING SECTION 506(B)'S ALLOWANCE OF EXPENSES AND SECTION 547(B)(5)'S GREATER AMOUNT TEST

A few scholars have recognized the possibility that an oversecured creditor might benefit from a pre-petition transfer, without significant consideration of how to address the conflict and protect the policy goals of preferential transfer law. Professor David Gray Carlson recognized that a clearly oversecured party who receives a pre-petition transfer and who invests that payment may benefit from the interest earned on that early payment.[26] That benefit does not undermine the value of the estate but comes instead from whichever party the creditor invests with. Professor Carlson also noted other post-petition possibilities, such as payment under Section 506(b), that might benefit the creditor, noting that courts differ on the ability to consider post-petition realities in calculating benefits under Section 547(b)(5).[27] In particular, Professor Carlson noted that "the secured party's equity cushion is being increased and, hence, so is her entitlement to post-petition interest under Section 506(b). Therefore, one cannot properly say that transfers to oversecured parties never diminish the bankruptcy estate."[28] Likewise, Professor Rafael Pardo has noted that:

---

[25] 11 U.S.C. § 541(a)(1) (mandating that property of the estate includes "all legal or equitable interests of the debtor in property as of the commencement of the case").

[26] David Gray Carlson, *Security Interests in the Crucible of Voidable Preference Law*, 1995 UNIV. ILL. L. REV. 211, 258.

[27] *Id*. at 259 (citing Tenna Corp. v. United States, 801 F.2d 819 (6th Cir. 1986)) ("[P]ostpetition events could not be considered in administering the hypothetical liquidation test."); LCO Enters. v. Walsh, 12 F.3d 938, 938 (9th Cir. 1993) (considering post-petition assumption of contract in making determination).

[28] Carlson, *supra* note 27, at 262 (citing Vern L. Countryman, *The Concept of a Voidable Preference in Bankruptcy*, 38 VAND. L.R. 713, 739–40 (1985)).

> [i]f 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.[29]

But neither article cites any caselaw in which a court deemed a pre-petition transfer to an oversecured creditor to constitute a preferential transfer because of such benefit. Neither article discusses the problem beyond a passing mention of its existence.

Ultimately, not all secured creditors will benefit from the receipt of a pre-petition transfer. The benefit arises when the pre-petition transfer allows a secured creditor to receive more in post-petition interest and fees under Section 506(b) than would have been possible absent the pre-petition transfer. Unfortunately, at the time that the trustee seeks to recover the preferential transfer, the amount of the benefit may not be easily determinable, since not all post-petition interest and fees have accrued at that time. However, the issue may be resolved by capping the amount available for an oversecured creditor to claim post-petition expenses under Section 506(b) to the amount that *would* have been available to the secured creditor without the pre-petition transfer. Applying such a rule to the Bank hypothetical, the court could determine that, as of the date of the bankruptcy filing, the Bank should have a $50,000 equity cushion and cap Bank's accrual of post-petition interest and fees at that amount. Such a rule ensures that the Bank cannot be advantaged by its pre-petition receipt of funds from the debtor. Instead, the Bank enters the bankruptcy with the same benefit that Section 506 envisions, without the need to label the initial transfer to the Bank preferential. While an amendment to the Code to clarify the intersection of Section 506 and Section 547 as to oversecured creditors could effectuate this policy, bankruptcy courts can also utilize their equitable authority

[29] Rafael I. Pardo, *On Proof of Preferential Effect*, 55 ALA. L.R. 281, 291 n.56 (2004).

under Section 105[30] of the Code to reconcile the conflict between the two sections and their purposes.

[30] Section 105 of the Code gives the Court broad equitable powers and provides that, "The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title." In exercising its § 105 powers, a court may consider the policies of the Bankruptcy Code, *In re* Wengert Transp., Inc., 59 B.R. 226, 231–32 (Bankr. N.D. Iowa 1986), but may not violate the express provisions of the Code, Norwest Bank Worthington v. Ahlers, 485 U.S. 197, 206 (1988). Because the Code provides for the return of preferential transfers and the comparison test as the final element of a preferential transfer, the Court could use its equitable powers to cap the allowance of § 506 expenses to give meaning to the language and intent of § 547(b)(5)'s language.