UNITED STATES BANKRUPTCY COURT
FOR THE EASTERN DISTRICT OF PENNSYLVANIA

In re	:	Chapter 7
ATS PRODUCTS CORPORATION	:	
Debtor	:	Bankruptcy No. 01-13220F
MICHAEL KALINER, CHAPTER 7 TRUSTEE[1]	:	
Plaintiff	:	
v.	:	
WILLOW GROVE BANK	:	
Defendant	:	Adversary No. 01-0273

....

MEMORANDUM

....

By BRUCE FOX, Chief Bankruptcy Judge:

The chapter 7 trustee, Michael H. Kaliner, has filed an adversary proceeding seeking to avoid as preferential the perfection of a security interest taken by defendant Willow Grove Bank ("Willow Grove") in property of the debtor. Willow Grove opposes this relief.

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[1] See infra note 4.

Before me now are cross-motions for summary judgment. Both parties contend that the material facts surrounding this proceeding are not in dispute. They differ, however, in their respective interpretations of 11 U.S.C. § 547(c)(5).

Upon review of the parties' submissions, and upon consideration of the stipulations orally made in open court, I agree that there are no material facts in dispute. Moreover, as will be discussed in detail, I conclude that the plaintiff/trustee is entitled to judgment as a matter of law.

I.

On January 10, 2000, ATS Products Corp. ("ATS") and Willow Grove entered into a "Loan, Security and Suretyship Agreement." As germane to these motions, this agreement provided ATS with a line of credit from Willow Grove not to exceed $5,000,000.00. Plaintiff's Ex. A ¶ 2.1. The purpose of the loan agreement was to refinance ATS's prior obligation to Summit Bank, to pay the closing costs associated with this refinancing loan, and to provide ATS with working capital. Id. ¶ 2.5. Repayment for all sums advanced by Willow Grove were to be secured by a lien upon, inter alia, ATS's present and future receivables and inventory. Id. ¶ 6.1.

Willow Grove asserts, and (for purposes of this proceeding) the trustee does not challenge, that, by June 8, 2000, ATS had utilized its line of credit fully and owed Willow Grove $5 million. Defendant's Ex. A.

By a document dated September 22, 2000, ATS and Willow Grove executed a first amendment to the January 2000 loan agreement. Plaintiff's Ex. B. Under the terms of this amendment, Willow Grove agreed to "establish three letters of credit on behalf of [ATS] in the aggregate amount of $1,548,670.00, and to increase the Loan in said amount." Id. at 1. Two of these letters of credit ("LOC") were in favor of Banta Catalog Group ("Banta") and one was in favor of R.R. Donnelley & Sons ("Donnelley"). Id. ¶ 2.3. There is no dispute that each of these three LOCs was an "Irrevocable Stand By Letter of Credit." See Defendant's Ex. B at WGB 02122, Ban 0126, WGB 02135. Nor is there any dispute that the additional loan amounts represented by these LOCs were to be secured by present and future inventory and receivables of ATS. Plaintiff's Ex. B at ¶ 5.

The parties stipulated that, by early October 2000, both Banta and Donnelley provided goods and services to ATS, with the debtor then obligated to pay for those goods and services by terms not disclosed. It is further stipulated that, by October 2000, Banta and Donnelley had been notified that Willow Grove had issued the three irrevocable LOCs. Therefore, as of October 2000, if ATS did not repay Banta and Donnelley according to the terms of their contracts, then Banta and Donnelley would look to the three LOCs for repayment, and Willow Grove would look to ATS for reimbursement.

On November 13, 2000, Willow Grove honored one LOC in favor of Banta in the amount of $568,334.93. Defendant's Ex. B at Ban 0129. On December 14, 2000, Willow Grove honored the second LOC in favor of Banta, also in the amount of $568,334.93. Defendant's Ex. B at WGB 02118. The third LOC was honored by the bank in favor of Donnelley in the amount of $407,888.38 around December 13, 2000. Defendant's Ex. B at WGB 02136.

On November 30, 2000, ATS submitted a balance sheet to Willow Grove, as it was required to do under the loan agreement. According to this document, ATS reported that its inventory had a value of $1,043,730.27 and that its outstanding receivables had a value of $244,286.12. Defendant's Ex. C at P9799.[2] The trustee's accountant has reported somewhat different totals. As of November 30, 2000, the accountant reports that ATS's balance sheet reflected $1,389.480.00 in inventory and $246,766.00 in receivables. Plaintiff's Ex. K (Exhibit C).

For reasons not disclosed, Willow Grove did not perfect its security interest in ATS's inventory and receivables until January 25, 2001, when it filed a financing statement with the Secretary of the Commonwealth of Pennsylvania. Defendant's Answer ¶ 9; Defendant's Answers and Objections to Plaintiff's Requests for Admissions # 5, Plaintiff's Ex. H; Defendant's Memorandum of Law at 2.

As of January 25, 2001, the date of perfection, ATS's balance sheet reflected an inventory value of $1,187.350.00. Plaintiff's Ex. K (Exhibit C). It also reflected total assets of $2,512,856.00 and total liabilities of $10,325,185.00. Id. As of March 7, 2001, its balance sheet reflected inventory values of $800,000.00 and

[2]There are three line items for receivables, and the amount listed above is the total of the three figures.

outstanding receivables of $149,000.00. Id. As of March 7, 2001, its total assets were listed at $11,201,685.00[3] and total liabilities at $13,953,818.00. Id.

The trustee's accountant has also reported that the debtor's estimates of the value of its assets were overstated. The trustee has been unable to collect any outstanding receivables, so the accountant has adjusted their value as of March 7, 2001 to $0.00. Id. at 8. Moreover, the trustee was only able to sell the debtor's inventory for $108,921.00, and so the value of the inventory as of March 7, 2001 was adjusted downward to that figure. Id. The parties have stipulated that the bankruptcy trustee has retained the proceeds of the sale of the inventory, subject to the present dispute over the validity of Willow Grove's perfected lien upon those proceeds.

The March 7, 2001 date was utilized by the accountant because ATS filed a voluntary petition in bankruptcy under chapter 11 on that day. On December 17, 2001, that chapter 11 case was converted to chapter 7, with Michael Kaliner, Esquire appointed as the chapter 7 bankruptcy trustee. Prior to this conversion, on May 3, 2001, the debtor in possession filed this preference complaint, in which the trustee has since elected to continue as party plaintiff.[4]

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[3]This increase in assets is solely due to ATS's inclusion of a $10 million disputed claim against Willow Grove. Plaintiff's Ex. K at 10 & Exhibit C. Absent that claim, its assets on March 7, 2001 were only reported as $1,201,685.00. Id. at Exhibit C. As the defendant believes the debtor's claim against it is valueless, it does not contest that ATS was insolvent on the date of its bankruptcy filing.

[4]Technically, upon conversion of a case from chapter 11 to chapter 7, if a trustee seeks to continue the prosecution of the case, he should seek substitution as party plaintiff under Fed. R. Bankr. P. 7025 (incorporating Fed. R. Civ. P. 25(c)). See In re S. Rachles, Inc., 131 B.R. 782, 785 (Bankr. D.N.J. 1991); In re Rose Marine, Inc., 1990 WL 10007382, at *1 (Bankr. S.D.

(continued...)

II.

As mentioned above, both parties now seek summary judgment.

Federal Rule of Bankruptcy Procedure 7056 incorporates Fed. R. Civ. P. 56 into bankruptcy adversary proceedings. The purpose of summary judgment is to avoid the expense and delay of an unnecessary trial when no material facts are in dispute and one of parties is entitled to prevail on the merits. See, e.g., Goodman v. Mead Johnson & Co., 534 F.2d 566, 573 (3d Cir. 1976), cert. denied, 429 U.S. 1038 (1977). In general, the standard for entry of summary judgment under Rule 56 is well established. As the Third Circuit Court of Appeals explained:

> Summary judgment is appropriate when the moving party is entitled to judgment as a matter of law and there is no genuine dispute of material fact. . . . In order to defeat "a properly supported summary judgment motion, the party opposing it must present sufficient evidence for a reasonable jury to find in its favor." Groman v. Township of Manalapan, 47 F.3d 628, 633 (3d Cir. 1995) (citing Anderson v. Liberty Lobby, Inc., 477 U.S. 242, 250-52, 106 S.Ct. 2505, 2511-12, 91 L.Ed.2d 202 (1986)). In essence, the non-moving party must demonstrate a dispute over facts that might affect the outcome of the suit. Id. Moreover, in reviewing the record, we must give the non-moving party the benefit of all reasonable inferences.

Hampton v. Borough of Tinton Falls Police Dept., 98 F.3d 107, 112 (3d Cir. 1996).

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[4](...continued)
Ga. 1990). As the defendant does not complain of this defect, I shall treat as waived the failure of the chapter 7 trustee to formally move to be substituted as party plaintiff for the former debtor in possession and shall substitute his name in the caption of this proceeding.

The application of these general principles is affected by the allocation of the evidentiary burden of persuasion were the dispute to proceed to trial. That is, a trial court's approach to summary judgment is dependent upon whether the party seeking summary judgment would have the burden of persuasion at trial. See generally 11 Moore's Federal Practice §§ 56.13[1], 56.13[3] (Coquellette et al. eds., 3d ed. 1999). This approach was well summarized in Adams v. Consolidated Rail Corp., 1994 WL 383633, at *1-*2 (E.D. Pa. 1994):

> The Supreme Court articulated the allocation of burdens between a moving and nonmoving party in a motion for summary judgment in Celotex Corp. v. Catrett, 477 U.S. 317 (1986). The Court held that where the movant is the defendant, or the party without the burden of proof on the underlying claim, the movant still has the initial burden of showing the court the absence of a genuine issue of material fact, but that this does not require the movant to support the motion with affidavits or other materials that negated the opponent's claim. Id. at 323. In contrast, where, as here, "the party moving for summary judgment is the plaintiff, or the party who bears the burden of proof at trial, the standard is more stringent." National State Bank v. Federal Reserve Bank, 979 F.2d 1579, 1582 (3d Cir. 1992). To sustain its initial burden under such circumstances, the movant must:
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>> "support its motion with credible evidence . . . that would entitle it to a directed verdict if not controverted at trial. In other words, the moving party must show that, on all the essential elements of its case on which it bears the burden of proof at trial, no reasonable jury could find for the non- moving party."
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> Fitzpatrick v. City of Atlanta, 2 F.3d 1112, 1115 (11th Cir. 1993). . . . If the movant makes such an affirmative showing, it is entitled to summary judgment unless the nonmoving party, in response, comes forward with significant, probative evidence demonstrating the existence of a triable issue of fact.

(citations omitted); accord In re White, 243 B.R. 498, 501 n.4 (Bankr. N.D. Ala. 1999).

As noted earlier, both parties agree that there are no material facts in dispute, and each has sought summary judgment as a matter of law. Furthermore, I note that 11 U.S.C. § 547(g) places the burden of proof upon the debtor to establish the five elements for the avoidability of a transfer under section 547(b). Willow Grove concedes, however, that such a burden has been met in this proceeding. Defendant's Memorandum at 3 ("The Bank does not dispute that the Trustee has established a prima facie case pursuant to section 547(b)").

Although Willow Grove raised a number of defenses in its answer to the complaint, it now acknowledges that the only potentially viable defense in this proceeding is based upon section 547(c)(5). Id. By virtue of section 547(g), the defendant has the burden of persuasion to demonstrate the nonavoidability of the transfers under section 547(c) by a preponderance standard. See, e.g., In re Chase & Sanborn Corp., 904 F.2d 588, 595 n.15 (11th Cir. 1990); J.P. Fyfe, Inc. of Florida v. Bradco Supply Corp., 891 F.2d 66, 69 (3d Cir. 1989); In re Contempri Homes, Inc., 269 B.R. 124, 128 (Bankr. M.D. Pa. 2001). This includes the defense under section 547(c)(5). See In re M. Paolella & Sons, Inc., 161 B.R. 107, 124 (E.D. Pa. 1993), aff'd, 37 F.3d 1487 (3d Cir. 1994) (Table).

III.

Before analyzing the legal issues involved, I note that the concept of an avoidable preferential transfer represents a longstanding congressional determination that creditors should not be permitted, either intentionally or unintentionally, to recover more from the debtor than other creditors with similar claims by virtue of transfers made in their favor just prior to the debtor's bankruptcy filing. At the time the preferential transfer is made, there may be nothing improper about it under state law. See Matter of Nelson Co., 959 F.2d 1260, 1266 (3d Cir. 1992). However, once the bankruptcy petition is filed, a trustee may avoid or set aside the transfer as preferential pursuant to 11 U.S.C. § 547.

Congress envisioned two overriding policies which would be enhanced by the trustee's ability to avoid preferential transfers. First, similar creditors would be treated equally in their receipt of distributions from the debtor's assets. Second, creditors would be discouraged from racing against each other to dismember the debtor, since an earlier recovery could later be set aside as preferential. H.R. Rep. No. 95-595, 95th Cong., 1st Sess. at 177-78 (1977).

The scope of a preferential transfer, as it is defined by section 547, embodies the balancing of a number of policy choices. See generally Thomas H. Jackson, Avoiding Powers in Bankruptcy, 36 Stan. L. Rev. 725 (1984). These are initially articulated by the provisions of section 547(b), which contain the essential elements of a preference as Congress chose to define it. Congress then recognized additional policy considerations by virtue of section 547(c). Certain transfers which might at first appear preferential, because they meet all the requirements of section 547(b), should not be so viewed for various reasons.

While section 547 identifies those transfers which may be avoided, section 550 governs the trustee's recoverability of transfers so avoided. 11 U.S.C. § 547(b) provides as follows:

> (b) Except as provided in subsection (c) of this section, the trustee may avoid any transfer of an interest of the debtor in property-
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> > (1) to or for the benefit of a creditor;
> > (2) for or on account of an antecedent debt owed by the debtor before such transfer was made;
> > (3) made while the debtor was insolvent;
> > (4) made-
> > > (A) on or within 90 days before the date of the filing of the petition; or
> > > (B) between ninety days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider; and
> >
> > (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 provision of this title.

11 U.S.C. § 550(a) provides in pertinent part that:

> [e]xcept as otherwise provided in this section, to the extent that a transfer is avoided under section . . . 547 . . . , 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 -
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> > (1) the initial transferee of such transfer or the entity for whose benefit such transfer was made; or

> (2) any immediate or mediate transferee of such initial transferee.

In this proceeding, ATS filed its bankruptcy petition on March 7, 2001. The ninety day reach-back period established by subsection 547(b)(4)(A) began on December 8, 2000. Willow Grove extended credit to ATS in January and September 2000 and took a security interest at those times, which were outside the preference reach-back period. The defendant perfected its security interest in ATS's inventory, however, in January 2001, within the preference period.

Section 547 is concerned with transfers of property interests of the debtor. Under section 101(54), a "transfer" includes the creation or perfection of a security interest. See, e.g., In re Nedrow, 1995 WL 562160, at *1 (Bankr. D. Idaho 1995) ("A 'transfer' is defined in the Code to include the transfer of a security interest in the debtor's property. 11 U.S.C. § 101(54)"); In re Holloway, 132 B.R. 771, 772 (Bankr. N.D. Okla. 1991) ("The act of perfecting a security interest is a transfer. 11 U.S.C. § 101(54)"). Thus, "the creation of a perfected security interest in property is itself a preference when the creation or perfection takes place during the preference period (and the other criteria are satisfied)." In re Melon Produce, Inc., 976 F.2d 71, 74 (1st Cir. 1992); see, e.g., In re Four Winds Enterprises, Inc., 94 B.R. 694 (Bankr. S.D. Cal. 1988).

In this proceeding, the trustee is seeking simply to avoid Willow Grove's perfection of its security interest on ATS's inventory, which occurred in January 2001. As no distribution or payment has been made to the defendant - the trustee has retained the proceeds of the inventory sale - relief appears to be sought solely under section 547 and not under section 550.

Section 547(e) has two provisions relevant to this proceeding. First, section 547(e)(2) provides:

> (2) For the purposes of this section, except as provided in paragraph (3) of this subsection, a transfer is made–
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> > (A) at the time such transfer takes effect between the transferor and the transferee, if such transfer is perfected at, or within 10 days after, such time, except as provided in subsection (c)(3)(B);
> >
> > (B) at the time such transfer is perfected, if such transfer is perfected after such 10 days; or
> >
> > (C) immediately before the date of the filing of the petition, if such transfer is not perfected at the later of--
> >
> > > (i) the commencement of the case; or
> > >
> > > (ii) 10 days after such transfer takes effect between the transferor and the transferee.

Thus, if a creditor takes a security interest in personal property of the debtor, but does not perfect that interest within ten days, then a transfer occurs under section 547(e)(2)(B) as of the date when lien perfection takes place. See In re Holloway, 132 B.R. at 772. Accordingly, the untimely perfection of a security interest within 90 days of a bankruptcy filing may represent a preferential transfer under sections 547(b) and 547(e)(2)(B). See In re Arnett, 731 F.2d 358 (6th Cir. 1984); In re Badger Lines, Inc., 206 B.R. 521, 527 (E.D. Wis. 1997); In re Fregosi, 23 B.R. 641 (Bankr. E.D. Va. 1982); see also In re Chenich, 100 B.R. 512 (9th Cir. BAP 1987) (applying section 547(e) to the perfection of an interest in real estate).

In this proceeding, Willow Grove did not perfect its security interest in ATS's inventory within 10 days of the creation of the lien interest, which was in January 2000 and September 2000. Moreover, it perfected its lien within 90 days of the debtor's bankruptcy filing. The defendant concedes that the requirements of section 547(b)(1) - (4), including insolvency and antecedent debt, are established by the record. In addition, because a bankruptcy trustee may use the strong-arm powers of section 544 to treat a creditor with an unperfected security interest as unsecured, the perfection of an earlier obtained security interest during the preference period would permit the creditor to be treated as a secured creditor entitled to the return of its collateral, rather than as an unsecured creditor. See generally In re Fox, 229 B.R. 160, 165-66 (Bankr. N.D. Ohio 1998) (payment to unperfected secured creditor was preferential); In re L & T Steel Fabricators, Inc., 102 B.R. 511 (Bankr. M.D. La. 1989) (same). Thus, the act of perfection of a security interest during the preference period satisfies (as Willow Bank acknowledges) the provisions of section 547(b)(5). See Matter of Vitreous Steel Products Co., 911 F.2d 1223, 1335 (7th Cir. 1990):

> To the extent that the Bank perfected its security interest in some of the property it repossessed, it improved its position in bankruptcy. Had the security interest in the after-acquired equipment not been perfected before the filing of bankruptcy, the security interest would have been unenforceable against the Trustee. Because the bankruptcy court found that the liquidation value of all of its collateral exactly equaled the amount of the Bank's debt, there would necessarily be some shortfall if some of those assets had to be shared by all the creditors. The Bank would collect only its proportionate share along with the other creditors in a Chapter 7 liquidation, and because the items in question are the only assets remaining in the estate, it is not possible that unsecured creditors will receive 100% of the value of their claims. By taking the transfer of the goods not covered in the financing

> statement (i.e., by perfecting its security interest), the Bank improved its position by that increment.

See also In re World Financial Services Center, Inc., 78 B.R. 239 (9th Cir. BAP 1987) (failure of the creditor to properly perfect its security interest caused prepetition transfer to be preferential).

Therefore, unless Willow Grove proves some defense under section 547(c), the pre-bankruptcy perfection of its lien on the debtor's inventory will be avoided. The only defense which Willow Grove now raises is found in section 547(c)(5).

IV.

A.

The second provision of section 547(e) germane to this dispute is found in subsection 547(e)(3). This provides that "a transfer is not made [under section 547] until the debtor has acquired rights in the property transferred." Thus, when a lender takes a security interest in after-acquired property, the transfer that is represented by the taking of such an interest will not take place until the borrower actually obtains the property. See generally In re Savig, 50 B.R. 1003 (D. Minn. 1985); In re Queen City Well Services, Inc., 1991 WL 1301308 (Bankr. D.N.D. 1991).

Congress decided to protect certain security interests in after-acquired property from avoidance under section 547(b). Subsection 547(c)(5) states:

> (c) The trustee may not avoid under this section a transfer–

> (5) that creates a perfected security interest in inventory or a receivable or the proceeds of either, except to the extent that the aggregate of all such transfers to the transferee caused a reduction, as of the date of the filing of the petition and to the prejudice of other creditors holding unsecured claims, of any amount by which the debt secured by such security interest exceeded the value of all security interests for such debt on the later of–
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> > (A)(I) with respect to a transfer to which subsection (b)(4)(A) of this section applies, 90 days before the date of the filing of the petition; or
> >
> > (ii) with respect to a transfer to which subsection (b)(4)(B) of this section applies, one year before the date of the filing of the petition; or
> >
> > (B) the date on which new value was first given under the security agreement creating such security interest;

Accordingly, "[s]ection 547(c)(5) insulates the transfer of a security interest in after-acquired property, i.e., a floating lien on inventory and receivables, provided that the creditor does not improve its position during the preference period." In re Smith's Home Furnishings, Inc., 265 F.3d 959, 965 (9th Cir. 2001). Another court reached a similar conclusion:

> The Bankruptcy Reform Act of 1978 ("the Act") established that a lender's perfected security interest in property later acquired independently by the debtor might not be insulated from preferential attack. Section 547(c)(5) of the Act carves out an exception for inventory or accounts receivable that protects the transfer of a security interest in after-acquired property, i.e., a "floating lien," provided that the creditor does not improve its position within the vulnerable period prior to bankruptcy. This exception:

> permits a creditor with, say, a 'floating lien' on the 'receivables' of such a company to maintain that lien as the specific accounts receivable are paid off, and replaced by new ones, without fear that a future bankruptcy trustee will mount a preference attack on new accounts receivable arising during the 'preference' period. . . . Insofar as the grant of a security interest in the new collateral (receivables or inventory that comes into existence during the preference period) improves the creditor's position (compared to his position at the beginning of the preference period), the grant of security constitutes a preference to the extent of the improvement.
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> Braunstein v. Karger (In re Melon Produce, Inc.), 976 F.2d 71, 75 (1st Cir. 1992) (citation omitted).

In re Wesley Industries, Inc., 30 F.3d 1438, 1442 (11th Cir. 1994) (footnote omitted).

As explained earlier, section 547(b)(5) limits a preference avoidance to transfers which provide a creditor with more than that creditor would receive in a chapter 7 liquidation. Because section 725 affords a duly perfected secured creditor the right to receive the proceeds of its collateral, see, e.g., In re Smith's Home Furnishings, Inc., 265 F.3d at 964, the improvement of position issue found in section 547(c)(5) is only germane to secured creditors who are undersecured at the onset of the preference period: viz., the value of their collateral is less than the debt owed to the creditor.

> Section 547(c)(5) applies to an undersecured creditor holding a security interest or "floating lien" on the debtor's inventory or receivables that was perfected prior to the preference period. It allows the trustee to avoid any improvement in the secured creditor's position during the 90 days prior to the filing of bankruptcy which occurs at the expense of unsecured creditors.

In re Universal Foundry Co., 30 F.3d 137 (Table), 1994 WL 409642, at *2 (7th Cir. 1994).[5] Moreover, from its express language, section 547(c)(5) does not protect the undersecured creditor with a security interest in inventory or receivables to the extent that such a creditor improved its position during the preference period at the expense of unsecured creditors.[6]

> The purpose of section 547(c)(5) is stated clearly in its legislative history:
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>> [This subsection] codifies the improvement of position test, and thereby overrules such cases as DuBay v. Williams [417 F.2d 1277 (9th Cir. 1969)]. A creditor with a security interest in a floating mass, such as inventory or accounts receivable, is subject to preference attack to the extent he improves his position during the 90-day period before bankruptcy. The test is a two point test, and requires determination of the secured creditor's position 90 days before the petition and on the date of petition. . . .
>
> H.R. Rep. No. 95-595, 95th Cong., 1st Sess., at 374 (1977), U.S. Code Cong. & Admin. News 1978, pp. 5787, 6330. Thus, a creditor with a perfected security interest in inventory and/or receivables receives a preference only to the extent that its position has improved during the ninety days pre-petition, unless it has provided new value to the debtor.

In re M. Paolella & Sons, Inc., 161 B.R. 107, 125 (E.D. Pa. 1993) (alterations in original), aff'd, 37 F.3d 1487 (3d Cir. 1994) (Table).

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[5]If the creditor were oversecured on the 90th day prior to bankruptcy - that is, the value of the inventory and receivables exceeded the amount owed - its position could not be improved and section 547(c)(5) would protect its security interest from avoidance.

[6]Willow Grove orally conceded at argument that, if one were to conclude that it had improved its position during the preference period, such improvement occurred at the expense of unsecured creditors.

The "improvement of position" test is concerned with the reduction during the preference period of the extent to which the secured creditor is undersecured. Unless there has been "new value" provided by the creditor during the preference period, the improvement of position analysis looks to the extent the creditor was undersecured as of the 90th day prior to the bankruptcy filing and then compares that result to the extent of any deficiency which existed on the day of the bankruptcy filing. Fluctuations in the amount of the deficiency occurring during the 90-day period are ignored:

> The "two-point net improvement" test of Section 547(c)(5) requires, in the present case, a computation of (1) the loan balance outstanding ninety days prior to bankruptcy; (2) the value of the accounts receivable on that day; (3) the loan balance outstanding on the day the bankruptcy petition was filed; and (4) the value of the accounts receivable on that day.

Matter of Missionary Baptist Foundation of America, Inc., 796 F.2d 752, 759-60 (5th Cir. 1986); see In re Carper, 63 B.R. 582, 584 (Bankr. W.D. Va. 1986) ("For purposes of § 547(c)(5), an undersecured creditor has improved its position when–and its perfected security interests may be avoidable to the extent that–the claim secured by inventory or receivables is less undersecured on the date of the filing of the bankruptcy petition than it was at the beginning of the preference period"). Another court explained this provision thusly:

> Section 547(c)(5) applies to secured creditors who have liens on the debtor's assets such as inventory and accounts receivable. The complicated language of this section simply means that the creditor cannot improve its secured position within the 90 days before the bankruptcy filing unless it extends new value to the debtor. For example, assume that on the ninetieth day before the filing of the debtor's bankruptcy case the creditor's claim is secured by inventory having a value of $3,000.00, and on the date of the bankruptcy filing, the value of the inventory has risen to $6,000.00. Unless this

> creditor has extended new value within the preference period, an avoidable preference exists in the sum of $3,000.00. (The $6,000.00 value at the date of filing less the $3,000.00 value at the inception of the preference period.) However, if new value was given by the creditor, the date that the new value was given becomes the operative date to test the amount of the potential preference as opposed to the ninetieth day before the bankruptcy filing. The extension of new value can, therefore, operate to reduce the amount of the avoidable preference.

In re Taylor, 151 B.R. 772, 778 (Bankr. N.D. Miss. 1993).

B.

At the outset, the trustee and Willow Grove dispute the applicability of section 547(c)(5) to this proceeding.

The trustee argues, based upon its language, that subsection 547(c)(5) can only apply when the secured creditor has a perfected security interest as of the 90th day prior to bankruptcy. See In re McLean Industries, Inc., 162 B.R. 410, 424 (S.D.N.Y. 1993) ("More importantly, § 547(c)(5) presupposes that the lien on receivables be perfected prior to the preference period"), rev'd on other grounds, 30 F.3d 385 (2d Cir. 1994), and cert. denied sub nom. U.S. Lines Reorganization Trust v. United States, 513 U.S. 1126 (1995); In re Phillips, 24 B.R. 712, 715 (Bankr. E.D. Cal. 1982):

> Section 547(c)(5) raised by the plaintiff as a safe harbor section is inapplicable to the present situation. This section is directed to floating liens that have been perfected outside the ninety day to one year avoiding period of 547(b) so as to limit the amount of security that they can encumber and not the instant situation of a transfer that occurs when a security interest is perfected within the voidable preference period.

Inferential support for this position would follow from those decisions which identify only two methods by which a secured creditor could improve its position under section 547(c)(5):

> An undersecured creditor holding a floating lien in inventory or receivables may potentially become less undersecured during this period in either of two ways, or a combination of both. First, the amount of its claim may have been reduced, by payment or otherwise, without an equivalent corresponding reduction in collateral. Second, and the primary focus of 547(c)(5), the value of the collateral itself may have increased over and above any increase in the amount of the claim. In either event, the creditor is less undersecured, there is a "reduction . . . of [the] amount by which the debt . . . exceeded the value of all security interests for such debt. . . ."

In re Carper, 63 B.R. at 584 (alteration in original). Both methods assume that the creditor has a perfected security interest in the floating collateral as of the onset of the preference period.

Willow Grove contends, however, that the section 547(c)(5) defense may be utilized by a creditor holding a lien on inventory even when a perfected security interest does not exist at the outset of the 90-day preference period. See In re Foxmeyer Corp., 286 B.R. 546, 568-69 (Bankr. D. Del. 2002):

> Notwithstanding the preceding points, the Trustee argues that § 547(c)(5) is inapplicable to the instant matter because the Defendants first acquired the Security Interests during the 90-day preference period that preceded August 27, 1996. The Trustee, in support of such position, argues, as a matter of law, that § 547(c)(5) only applies (a) if a creditor had a lien on inventory and/or receivables prior to the beginning of the 90-day preference period, and (b) to the extent that such creditor's lien position did not improve during such 90-day period. Unfortunately for the Trustee, the plain language of § 547(c)(5)(B) explicitly provides that such preference exception applies even if a creditor does not first obtain his

> inventory/receivables lien until at some point during the 90-day preference period; indeed, § 547(c)(5)(B) mandates that, if an inventory/receivables lien is obtained during the preference period, then improvement in a creditor's secured position is measured from the date of such acquisition to the point of a bankruptcy petition filing. Therefore, the Court holds, as a matter of law, that a creditor need not have had a lien on inventory and/or receivables prior to the beginning of the 90-day preference period in order for § 547(c)(5) to apply.

See also In re American Ambulance Service, Inc., 46 B.R. 658 (Bankr. S.D. Cal. 1985).

This latter interpretation focuses upon the language of section 547(c)(5)(B) and notes that the period relevant to the improvement of position test may begin at a date later than 90 days prior to the bankruptcy filing, if on this later date the creditor first provided new value under its security agreement. If so, then the creditor could not hold a perfected security interest at the outset of the ninety-day preference period.

If the section 547(c)(5) defense can apply even when there is no perfected security interest in receivables on the 90th day before bankruptcy, then Willow Grove maintains that it has not improved its position during the preference period. It reaches this conclusion by arguing that the value of the debtor's inventory and receivables was reduced during that preference period from approximately $1,043,730.27 and $244,286.12 respectively - utilizing ATS's November 30th balance sheet data - to $108,921.00 and $0.00 on the petition date - utilizing the trustee's accountant's report. Second, the defendant contends that it increased the amount loaned to the debtor during the preference period by $976,243.31 - represented by the final two LOCs it honored in mid-December 2000.

Accordingly, Willow Grove contends that the amount by which it was undersecured actually increased during the preference period (from about $5.5 million on the 90th day, to roughly $6.4 million on the date of filing); thus, it never improved its position as a secured creditor. If so, then it maintains that the perfection of its lien on the inventory, while representing a transfer of property during the preference period, and while affording it the right to receive the proceeds of the trustee's inventory sale, may not be avoided under section 547.

For the following reasons, I find the defendant's analysis of the improvement of position test unpersuasive because it overlooks the language of section 547(c)(5) when applied to the pre-preference period issuance of an irrevocable standby letter of credit.

C.

First, I shall assume arguendo that the Foxmeyer and American Ambulance decisions relied upon by Willow Grove were correctly decided. It is important to note, however, that both cases involved challenges to security interests relating to loan transactions, where both the loan transactions themselves and the perfection of the security interest took place during the ninety-day preference period. See In re Foxmeyer Corp., 286 B.R. at 568-69 (loan agreement took place on June 19, 1996 and the bankruptcy petition was filed on August 27, 1996). Indeed, the court in American Ambulance phrased the issue before it as follows:

> It is clear that the language of § 547(c)(5)(B) is broad enough to cover a situation such as this one where both the new value is given and the security interest is perfected during the 90-day period prior to the filing of the petition. The question remains whether the 40-day delay [during the preference period] in recording the security interest precludes the Bank from having a "perfected security interest" making that exception inapplicable and the transfer consequently unavoidable § 547(c)(5).

In re American Ambulance Service, Inc., 46 B.R. at 660.

In other words, both of these decisions relied upon subsection 547(c)(5)(B), by which the improvement of position test is measured initially from "the date on which new value was first given under the security agreement creating such security interest." While one would expect that the "contemporaneous exchange" defense provided by section 547(c)(1), see In re American Ambulance Service, Inc., 46 B.R. at 659; see generally In re Pitman, 843 F.2d 235 (6th Cir. 1988), would protect secured lenders who first provide loans to debtors shortly before their bankruptcy filings, the Foxmeyer and American Ambulance decisions would also permit section 547(c)(5) to be used in loan transactions involving inventory and receivables when that other defense was unavailable.

In contrast to those two decisions, in this adversary proceeding, the underlying loan agreement between ATS and Willow Grove took place well outside the preference period, in January 2000, with the act of perfection occurring within 90 days of the bankruptcy filing. This is significant because the phrase "new value" utilized in section 547(c)(5)(B) is defined by section 547(a)(2) as follows:

> (2) "new value" means money or money's worth in goods, services, or new credit, or release by a transferee of property previously transferred to such transferee in a transaction that is neither void nor voidable by the debtor or the trustee under any applicable law, including proceeds of such property, but

> does not include an obligation substituted for an existing obligation.

As noted above, subsection 547(c)(5) directs that the improvement of position is to be measured from the later of the date upon which the creditor <u>first</u> provided new value under the security agreement or 90 days prior to the bankruptcy case. Where, as here, the loan and security agreement are entered into outside the preference period and the loan funds are transferred to the borrower at that time (or shortly thereafter), the later date under section 547(c)(5) will always be the 90th day before the bankruptcy filing.

Thus, if a lender and debtor enter into a loan agreement with a floating lien on inventory and/or receivables, if loan proceeds are advanced at the time of the loan, and if this loan agreement occurs outside the preference period, the first measurement point in the improvement of position test must be the 90th day prior to the bankruptcy filing, since the "new value" would first be provided at the time of the loan. If this lender perfects its security interest outside the preference period and then, within the 90-day period, advances additional funds to increase the loan balance, the improvement of position test (and not section 547(c)(5)(B)) will give credit for those additional funds.

A more difficult problem - and the one posited by the defendant here - would arise if this prepetition creditor provided a loan (and new value) more than 90 days before bankruptcy, obtained a security interest on inventory at the time of the loan, but did not have a perfected security interest on the 90th day; then, during the preference period, it advanced additional funds and later perfected its security agreement. If the contemporaneous exchange defense, section 547(c)(1), and the new value defense, section 547(c)(4), were inapplicable, could the creditor be protected by subsection

547(c)(5) whenever the additional loan amount exceeded the value of the inventory at the time of the bankruptcy filing? The trustee would answer this question in the negative and Willow Grove in the affirmative.

I find it unnecessary to resolve that issue because, in this proceeding, Willow Grove did not advance additional funds to ATS during the preference period; rather, it honored two standby letters of credit[7] which had been issued prior to the onset of the preference period and which had also become irrevocable outside the preference period. Thus, ATS's debt to Willow Grove did not increase during the 90 days immediately before bankruptcy.

D.

There appear to be two types of letters of credit: commercial letters and standby letters. See Matter of Val Decker Packing Co., 61 B.R. 831, 837 (Bankr. S.D. Ohio 1986). "The standby letter of credit functions as a 'back up' against customer default, the default of the customer triggering the insurer's obligation, somewhat like a guaranty." Id. at 837; accord, e.g., In re Carley Capital Group, 118 B.R. 982, 984 (Bankr. W.D. Wis.), aff'd, 119 B.R. 646 (W.D. Wis. 1990). In addition, letters of credit may be irrevocable or revocable. Matter of Val Decker Packing Co., 61 B.R. at 837; see

[7]The first LOC was honored in November, 2000, before the 90-day period began.

generally 13 Pa. C.S.A. § 5106. Willow Grove acknowledges in this dispute that it issued three standby, irrevocable letters of credit in September or October 2000.

> The basic parties to all types of letters of credit are three: the customer, the issurer and the beneficiary. The customer is the person who causes the issurer [sic] (usually a bank) to issue the letter of credit to a beneficiary, the person who is entitled to draw or demand payment under the terms of the letter of credit. . . . The issuance of a letter of credit represents three independent agreements:
>
>> [T]he issuing bank and its customer agree on the terms in the letter to be issued and the means by which the customer will reimburse the bank; the bank issues the letter to a beneficiary which receives rights against the bank under terms of the letter (no consideration needs to flow from the beneficiary to the issuing bank . . . and the underlying sales contract (or other transaction) between the customer and the beneficiary.

Matter of Val Decker Packing Co., 61 B.R. at 837 (citations omitted).

> A standby "letter of credit" is a common means of contingent financing. Such an arrangement involves a buyer contracting with a financial institution, whereby the institution will serve as a guarantor of a certain amount of money in a transaction between the buyer and a third-party seller. If the buyer breaches his agreement with the seller, the seller may seek payment from the institution. . . .
>
> A letter of credit transaction actually consists of three distinct contracts: (I) the underlying purchase-and-sale agreement between buyer and seller; (ii) an application for the letter of credit filed with the financial institution by the buyer, i.e., a contract between the bank and buyer; and (iii) the letter of credit itself, a contract between the bank and seller, whereby the bank will pay a certain amount of money to the seller in

> the event that the buyer fails to pay the seller in breach of the underlying contract between the buyer and seller.

FDIC v. Plato, 981 F.2d 852, 854 n.3 (5th Cir. 1993) (citations omitted); accord Matter of Coral Petroleum, Inc., 878 F.2d 830, 832 (5th Cir. 1989); see also 13 Pa. C.S.A. § 5102.

In this dispute, ATS paid Willow Grove a fee to issue the three irrevocable letters of credit. Once those LOCs were issued, and once Banta and Donnelley provided the underlying goods or services to ATS, Willow Grove was obligated to honor those credit instruments, as they were irrevocable. See Matter of Val Decker Packing Co., 61 B.R. at 837-38; In re Briggs Transportation Co., 37 B.R. 76, 79 (Bankr. D. Minn. 1984); Peled v. Meridian Bank, 710 A.2d 620, 623-24 (Pa. Super. 1998). When Willow Grove honored these three letters, it paid its own funds to Banta and Donnelley. See Matter of Compton Corp., 831 F.2d 586, 589 (5th Cir. 1987). Once Willow Grove honored the letters of credit, ATS's contingent liability to repay the bank those sums - which liability arose when the LOCs were first issued - became fixed.

By virtue of 11 U.S.C. § 101(12), a "debt" is defined as "a liability on a claim." A "claim" is defined as a "right to payment, whether or not such right is . . . liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured or unsecured." 11 U.S.C. § 101(5)(A). Thus, a "debt" was created in favor of Willow Grove against ATS: when ATS contracted with Willow Grove to issue the three letters of credit; when Willow Grove delivered them to Banta and

Donnelley; and when ATS entered into agreements for good and services with Banta and Donnelley. These events all occurred prior to the onset of the preference period. While I appreciate that this debt was "contingent" upon the debtor's default in payment to the two beneficiaries, a "debt" for bankruptcy purposes nonetheless existed. As explained by one court:

> Thus, from the moment the letter of credit was issued, Norwest Minneapolis had a present claim against Briggs for reimbursement, contingent upon Norwest Minneapolis actually paying a conforming draft. Accordingly, the claim arose long before Briggs filed its Chapter 11 petition. Under the Bankruptcy Code a right to payment is considered a "claim", "whether or not such right is . . . contingent." 11 U.S.C. § 101(4)(A). There is no dispute that Norwest Minneapolis was legally obligated to, and did, pay the letter of credit. Thus, the contingency occurred and the claim is now fixed.

In re Briggs Transportation Co., 37 B.R. at 79; see Matter of Val Decker Packing Co., 61 B.R. at 841.

E.

I now return to the specific language of section 547(c)(5). It is a "fundamental canon that statutory interpretation begins with the language of the statute itself." Pennsylvania Department of Public Welfare v. Davenport, 495 U.S. 552, 557-58 (1990). Moreover, "[w]here the statutory language is clear, our 'sole function . . . is to enforce it according to its terms.'" Rankin v. DeSarno, 89 F.3d 1123, (3d Cir. 1996) (quoting Rake v. Wade, 508 U.S. 464, 471 (1993), which quoted, in turn, United States v. Ron Pair Enterprises, Inc., 489 U.S. 235, 241(1989), cert. denied sub nom. DeSarno v. Allegheny County, 519 U.S. 1108 (1997)); accord, e.g., Hartford Underwriters Insurance Co. v. Union Planters Bank, N.A., 530 U.S. 1, 6 (2000).

This statutory provision states the general premise that a "trustee may not avoid . . . a transfer . . . that creates a perfected security in inventory . . . or the proceeds of [inventory]," unless an exception applies. 11 U.S.C. § 547(c)(5). This statutory exception in favor of avoidance - an improvement of position - arises when the transfer which created a perfected security interest "caused a reduction, as of the date of the filing of the petition . . . , of any amount by which the debt secured by such security interest exceeded the value [of the security interest] for such debt" on the 90th day prior to the bankruptcy filing. Id. (emphasis added).

As discussed earlier, since Willow Grove first provided new value to ATS under its security agreement months before the preference period, the provisions of subsection 547(c)(5)(B) are inapplicable, and the first point for the improvement of position test is the 90th day before the bankruptcy filing. On the 90th day prior to ATS's bankruptcy filing, the "debt" owed to Willow Grove was approximately $5 million plus the contingent obligation equal to the value of the three letters of credit. The total "debt" on that date was therefore more than $6.5 million.[8] As the security interest was unperfected, this debt would be treated for bankruptcy purposes as unsecured. The perfection of that interest in January 2001 resulted in a transfer which increased the value of the security interest by the value of the inventory on the petition date: $108,921.00. The amount of the debt remained unchanged during the preference period, except for accruing interest.

Thus, the transfer - i.e., the perfection of its lien - reduced Willow Grove's undersecured status and therefore improved its position during the two relevant points of section 547(c)(5). Given the defendant's concession that other unsecured creditors would be prejudiced by this improvement in position, I must conclude that, even if section 547(c)(5) applies in these circumstances, the exception to the section 547(c)(5) defense

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[8]Willow Grove argues that contingent debts should not be included in the improvement of position calculation under section 547(c)(5). It likens such debts to a line of credit which has not been fully utilized by the debtor. This argument is unpersuasive.

First, as Congress saw fit to use the term "debt" in section 547(c)(5) and to define it broadly in section 101, I am not at liberty to ignore its directive. See Pennsylvania Department of Public Welfare v. Davenport, 495 U.S. at 557-58 (since section 1328(a) uses the term "debt" to define the scope of the chapter 13 discharge, the broad definition of "debt" found in section 101 must be applied).

Second, the issuance of an irrevocable letter of credit is materially different from the granting of a line of credit. A borrower/debtor may elect not to use the credit line; a customer/debtor may not cancel the irrevocable letter of credit. (Of course, the customer/debtor may repay the beneficiary and so prevent a letter of credit from being called; however, a debtor may always reduce any type of debt by payment.) Indeed, if ATS had sought to refinance its obligation to Willow Grove prior to the letters of credit being honored, but after their issuance, the payoff figure would have included both the used credit line and the bank's obligation under the outstanding letters of credit.

has been demonstrated by the plaintiff on this summary judgment record. Therefore the trustee is entitled to prevail.

V.

In sum, there are no material facts in dispute in this adversary proceeding. The documents and stipulations of the parties resolve all relevant factual issues.

As to the parties' legal dispute, the defendant seeks to validate the perfection of a security interest, which interest arose one year earlier, by lien recordation during the 90-day perfection period. Generally, such conduct is a classic preferential transfer; nonetheless, because the security interest involves future inventory, the defendant argues that such a transfer is unavoidable under section 547(c)(5), at least when a creditor provides additional funds during the preference period which exceed the value of the inventory as of the date of the bankruptcy filing. The plaintiff implicitly counters that the transfer caused by the lien perfection is unavoidable only when insulated by provisions such as section 547(c)(1); he explicitly maintains that section 547(c)(5) cannot protect a floating lien which arises more than 90 days prior to a bankruptcy filing and is unperfected at the onset of the preference period.

Here, the undisputed facts demonstrate that, during the preference period, the defendant honored two irrevocable letters of credit issued to creditors of ATS more than 90 days prior to bankruptcy. The payment of an irrevocable letter of credit under these circumstances did not increase the "debt" owed to the defendant during the preference period. Accordingly, even if section 547(c)(5) were to apply to this dispute, there has been an improvement of position during the preference period, and the perfection of the lien is preferential.

An appropriate order shall be entered.

UNITED STATES BANKRUPTCY COURT
FOR THE EASTERN DISTRICT OF PENNSYLVANIA

In re	:	Chapter 7
ATS PRODUCTS CORPORATION	:	
Debtor	:	Bankruptcy No. 01-13220F
MICHAEL KALINER, CHAPTER 7 TRUSTEE	:	
Plaintiff	:	
v.	:	
WILLOW GROVE BANK	:	
Defendant	:	Adversary No. 01-0273

....

ORDER

....

AND NOW, this 5th day of June, 2003, for the reasons state in the accompanying memorandum, it is hereby ordered that the plaintiff's motion for summary judgment is granted and the defendant's motion for summary judgment is denied. The defendant's pre-bankruptcy perfection of its security interest in the inventory of the debtor is avoided as a preferential transfer pursuant to 11 U.S.C. § 547.

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BRUCE FOX
Chief Bankruptcy Judge

IN RE:	Chapter 7
ATS PRODUCTS CORPORATION	Bankruptcy No. 01-13220F
Michael Kaliner, Chapter 7 Trustee	Adversary No. 01-0273
v.	
Willow Grove Bank	

Copies of the Chief Bankruptcy Judge's Memorandum and Order dated June 5, 2003, were mailed on said date to the following:

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