Getting the Question Right on Floating Liens and Securitized Assets

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This Article reconceptualizes the relationship between floating liens and static liens in order to refine the theoretical and practical treatment of floating liens under the Bankruptcy Code. This reconceptualization in turn lends clarity to the regulation of asset securitization as a form of financing. Traditionally, floating liens, such as security interests in inventory or accounts receivable, have been controversial because they appear to involve debtors granting interests in property they do not own. This Article contends that this argument is misguided because most, if not all, liens involve the debtor granting interests not yet owned. However, the concern surrounding floating liens is justified because of the unique principles of individuation involved in fluid assets, which grants fluid assets a unique degree of dynamism and makes floating liens ideal vehicles for preferential behavior. Understanding the differences between the principles of individuation unifying what are traditionally conceived of as fluid assets and static assets not only permits an accurate understanding of the true difficulties in policing floating liens but also provides a theoretical basis for differentiating between preferential transfers between the debtor and creditor and what this Article refers to as “recuperative transfers” (which should be permitted) from the debtor to the creditor. This Article leverages these theoretical insights to fashion the Matrix Test, an alternative to the current Two-Point Net Improvement Test under the Bankruptcy Code. This new test holds significant advantages in accommodating the dynamism of fluid assets and detecting preferential behavior. This Article then argues that asset securitization provides a first-best solution to the problems created by the unique dynamism of fluid assets because asset securitization severs a fluid asset from the originating business, the source of a fluid asset’s dynamism. The current jurisprudential concern that asset securitization is actually a form of floating lien is misguided because it fails to recognize the fundamental economic differences between floating liens and asset securitization, and the current jurisprudential restrictions on asset securitization, expressed in the true sale requirement, are self-defeating because they ultimately restrict an ideal alternative to the difficulties of policing floating liens.


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Introduction

Floating liens and asset securitization are prominent features in the topography of modern corporate finance. Small- and medium-sized firms issue the bulk of secured debt in the United States. The only substantial assets most small firms and even some medium-sized firms possess are their inventory and accounts receivable (in this Article, I will refer to inventory, accounts receivable and other similarly dynamic assets as “fluid assets”). For these firms, floating liens often represent the only means of acquiring secured debt. Asset securitization is a relatively recent innovation that permits large firms to achieve greater efficiencies in raising capital from accounts receivable and other collateral. Asset securitization is the fastest-growing form of capital formation in the United States, and its use is rapidly expanding worldwide.

The importance of floating liens and asset securitization both belies and emphasizes the troubled jurisprudence sustaining both species of financing. The 1960s witnessed a heated academic exchange concerning the validity of floating liens in bankruptcy proceedings. The exchange centered on the issue of how a debtor could grant an interest in property it

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3 Steven L. Schwarz, The Alchemy of Asset Securitization, 1 STAN. J.L. BUS. & FIN. 133, 133 (1994) [hereinafter Schwarz, Alchemy].
4 Id.
5 Kronman, supra note 2, at 120.
did not yet own.⁶ Considerable efforts aimed at answering this intuitive objection produced several conceptual rejoinders.⁷ The persuasiveness of these replies is uncertain at best, and after the enactment of the Bankruptcy Reform Act of 1978,⁸ the discussion effectively died without a definitive answer. Both the courts and academia are currently experiencing a warm debate concerning the requirements for asset securitization.⁹ The securitization of an asset raises suspicions that the transaction is actually a secured loan disguised as a sale in order for the debtor and creditor to achieve bankruptcy remoteness.¹⁰ Although the courts have delineated several factors in determining whether a transaction is a true sale or a disguised loan,¹¹ the analysis is at odds with conventional definitions of a true sale.

This Article reconceptualizes the debate surrounding floating liens by emphasizing the economic similarities between liens on fluid assets and liens on static assets. Specifically, both types of liens entail a series of subsequent transfers between the debtor and the creditor because fluid assets and static assets must both be maintained. The criticism that floating liens involve a debtor granting interests in something it does not yet own is accurate but misguided. The actual difficulty with fluid assets is not that they are necessarily dynamic but that they are radically dynamic. Consequently, common experience does not provide a sufficiently robust idea of their appropriate content, making liens on fluid assets uniquely difficult to police. These insights provide the foundation for a unified treatment of liens on fluid assets and liens on static assets under the Bankruptcy Code and inform recommendations on policing strategic behavior involving floating liens.

Themes in the jurisprudence on floating liens have permeated the treatment of securitized assets. Judicial concerns that asset securitization is merely another species of floating liens are predicated on nominal similarities between asset securitization and floating liens and neglect the fundamentally different economic structures underlying both forms of financing. Indeed, asset securitization represents a first-best solution to the problems involved in pledging fluid assets because it severs fluid assets from the originating business, eliminating the dynamism of the fluid assets

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⁶ Id. at 122-24.
⁷ Id. at 124-31.
¹⁰ Schwarcz, Parts, supra note 9, at 143-45.
¹¹ Id. at 143-49.
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and the opacity surrounding their content. The strict standards for asset securitization established in the “true sale” requirement are not merely harmful in that they limit the use of a promising method of raising capital, they are self-defeating because they inadvertently restrict the use of an ideal alternative to floating liens.

In Part I of the Article, I review the historical positions in the debate concerning the floating lien. In Part II, I offer a new analysis on the relation between fluid assets and static assets and the challenges involved in a legal treatment of fluid assets. In Part III, I deploy this framework to analyze the adequacy of the Two-Point Net Improvement test of § 547(c) of the Bankruptcy Code and develop an alternative method of determining the preferentiality of floating liens, which I call the “Matrix Test.” In Part IV, I review the development of the “true sale” requirement for asset securitization and invoke the themes generated from the review of the jurisprudence on floating liens to properly contextualize and resolve the tensions between the “true sale” requirement and conventional understandings of a sale.

I. The Historic Jurisprudential Analysis of Transactions Involving Fluid Assets

In this Part, I revisit the historical debate concerning the status of floating liens to unearth the actual difficulties animating judicial and academic concern surrounding them. The classic objection against floating liens rests upon the intuition that a debtor cannot grant rights in something it does not own (which I refer to as the “Transfer Intuition”). Unfortunately, the Transfer Intuition is too blunt an imperative to effectively distinguish between purely fraudulent encumbrances (where the debtor pledges completely fictional collateral) and restorative transfers (where the debtor promises to restore the value of collateral that it consumes through use of the collateral). Consequently, the Transfer Intuition invalidates a substantial majority of liens, not merely floating liens. This basic flaw in the historic criticism of floating liens undermines the entire historic debate surrounding floating liens.

A. The Attack on the Validity of Floating Liens in Bankruptcy Proceedings

Bankruptcy proceedings involving floating liens will often have the following form: on January 2, the creditor lends to the debtor and takes a security interest in the debtor's entire current inventory and any and all inventory the debtor will acquire. On the same day, the creditor files a complete financing statement at the appropriate state office, attempting to perfect the security interest. On June 6 of the same year, the debtor becomes insolvent, and the creditor learns of the debtor's insolvency. On December 1 of the same year, the debtor files for bankruptcy. The debtor completely refreshes its inventory every month.

Section 60(a)(1) of the Bankruptcy Act prohibits a preferential transfer between a creditor and a debtor. A transfer is preferential if it (1) is to or for the benefit of the creditor, (2) is on account of an antecedent debt, (3) is made while the debtor is insolvent, (4) is made within four months of the petition for bankruptcy, and (5) enables the creditor to receive more than it would receive in a liquidation had the transfer not been made. The above example satisfies all but one of the requirements for a preferential transfer. The transfer of rights in inventory acquired immediately before the bankruptcy was in the creditor's interest, made while the debtor was insolvent, and made within four months of the bankruptcy petition. The issue at the heart of the debate is whether the transfer was for an antecedent debt. More specifically, the issue is whether the debtor granted the creditor a security interest in the present inventory on January 2 (in which case the transfers would not be avoidable) or whether the debtor granted the creditor a security interest when the debtor acquired rights in the inventory (in which case the transfers would be avoidable).

The first of two crucial arguments proposed by opponents of the floating lien is to interpret § 60 of the Bankruptcy Act to require that the transfer of a security interest from a debtor to a creditor occur after the security interest is fully perfected. One of the conditions that section

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13 Both the Bankruptcy Code and the Uniform Commercial Code have been revised since 1960. In order to preserve the original argument, I refer to sections and requirements of the old Code when discussing the original debate.
15 Id.
16 The example is fashioned to make the entire floating lien preferential. If the fluid asset is not especially volatile, only a portion of the floating lien may be preferential. This variation, however, does not impact the analysis in any meaningful manner.
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9-203(1) of the UCC provides for perfection is that a security interest cannot attach unless the debtor has rights in the collateral. The debtor in this example received its inventory in the past month. Assuming that the debtor immediately grants the creditor a security interest upon receipt of new inventory, the creditor’s security interest in the present inventory is perfected in the past month, well within the four-month requirement defined by § 60 of the Bankruptcy Act. Consequently, the debtor granted the creditor a security interest in the inventory only when the last item of the present inventory was received because a portion of the inventory was perfected in the last month. This point in time is after the point when the creditor provided the debtor with the loan proceeds and therefore makes the transfer for an antecedent debt, a voidable preference.

Section 9-108 of the UCC seems to diffuse this problem by simply deeming that the transfer was not on account of an antecedent debt. Section 9-108 of the UCC provides that “after-acquired collateral shall be deemed to be taken for new value and not as security for an antecedent debt.” The rejoinder to this possibility, and the second crucial move in the argument against floating liens, is that the Bankruptcy Act does not defer to the UCC in order to determine whether a debt is an antecedent debt. The Bankruptcy Act refers to state law (i.e., the UCC) to determine when debt is incurred and when a transfer occurs. However, once state law has established these two points, the Bankruptcy Act implicitly determines antecedence by inquiring whether the transfer occurred after the debt was incurred. Section 9-108 does not defeat the proposed argument against the validity of floating liens in bankruptcy proceedings because the UCC cannot trump the Bankruptcy Act in determining whether a transfer is on account of an antecedent debt.

B. The Defense of Floating Liens in Bankruptcy Proceedings

Proponents of recognizing floating liens (the “Proponents”) in bankruptcy proceedings have marshaled three arguments in defense of the validity of floating liens in bankruptcy proceedings. Two of these arguments attempt to reconceptualize the exchange between the creditor and debtor so as to make the transfer on account of a contemporaneous debt. The third, and most popular, argument is a direct assault on the interpretation of § 60 of the Bankruptcy Act offered by the opponents of floating liens (the “Opponents”).

20 Countryman, supra note 17, at 276.
21 Id.
22 Id.
The first argument, and perhaps the most creative reply to the Opponents' challenge, is an argument based on the "Entity Theory" of fluid assets. The Entity Theory, introduced in *Manchester National Bank v. Roche*, conceives of the collateral supporting a floating lien as consisting not of the individual items in the inventory or accounts receivable, but the entire stream of those items. The Proponents argue that while the individual components of floating liens, like a stream, may be in constant flux, the asset remains constant. When a creditor takes a security interest in a fluid asset, it is acquiring a security interest in the stream, not the individual items composing the stream. Therefore, subsequent changes in the content of inventory or accounts receivable do not entail additional transfers from the debtor to the creditor because they are not additional transfers of collateral—the stream itself. This reconceptualization purges the floating lien of after-acquired property problems by essentially arguing that floating liens do not involve after-acquired property. There is one constant entity, the stream of goods or accounts, that the debtor possesses and transfers to the creditor at the time of the initial loan. This allows the creditor to fully perfect the floating lien at the point when the loan funds are distributed, making the transfer pursuant to a contemporaneous debt.

The second strategy, termed the "Substitution of Collateral Theory," is to conceptualize additional consideration coinciding with the additional transfers. Advocates of the Substitution of Collateral Theory grant that shifts in inventory and accounts entail additional transfers to the secured creditor. They also observe, however, that when a debtor disposes of encumbered fluid assets, it is disposing of assets in which the secured creditor has an interest. The secured creditor loses something of value, its security interest in the particular item disposed, when fluid assets change. As part of this loss, the secured creditor grants the debtor something of value, the disposition of the property. This additional consideration, when paired with the additional transfer, creates a situation in which there is a contemporaneous exchange. Even though there are additional transfers, they are not preferential because they are for additional consideration, the

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23 186 F.2d 827, 831 (1st Cir. 1951); see also Ray D. Henson, "Proceeds" Under the Uniform Commercial Code, 65 Colum. L. Rev. 232, 232-37 (1965) (analogizing the concept of inventory to the Mississippi River and citing the conception of inventory as a unity by Manchester National Bank as a "simple common-sense approach").

24 Henson, supra note 23, at 235.


26 Hogan, supra note 25, at 563.
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assent of the secured creditor to dispose of the old assets, and are not on account of an antecedent debt.

The third argument, and arguably the most popular response to the challenge against floating liens, was articulated by Judge Hufstedler in her decision in *DuBay v. Williams*. Judge Hufstedler noted that § 60(a) of the Bankruptcy Act did not actually require that a security interest be fully perfected before the security interest can be transferred from the debtor to the creditor, as the Opponents had argued. Rather, § 60(a) merely requires that the security interest be “so far perfected that no subsequent lien upon such property obtainable by legal or equitable proceedings on a simple contract could become superior to the rights of the transferee.”

Returning to the example of a floating lien in bankruptcy, the secured creditor attains a security interest in the new inventory or accounts as soon as the debtor acquires rights in the new items. Any other creditor, even a hypothetical lien creditor, is also bound by the limitation imposed by section 9-203 of the UCC, that the debtor may only grant a security interest in collateral in which it has rights. Therefore, the best result that any other creditor could achieve would be to acquire a security interest as soon as the debtor acquired rights in the new property. In other words, the best legal position that any other creditor could attain, in relation to the secured creditor who has encumbered the fluid asset, is parity. At best, the additional lien would only have an equal priority to the floating lien of the original secured creditor. Yet, § 60(a) requires that the subsequent creditor have superior rights to those of the transferee. Understanding § 60(a) in this light, the security interest between the creditor and the debtor is sufficiently perfected at the point when loan proceeds were transferred (January 2 in the example) to allow a transfer of the security interest from the debtor to the creditor because no other creditor can trump the secured creditor’s position (although other creditors may equal it). This makes the transfer contemporaneous with the debt, not subsequent to the debt, removing the transaction from the scope of § 60(a)’s avoidance powers.

C. Judicial Response to the Debate Concerning Floating Liens

A quick survey of the cases involving the validity of floating liens in bankruptcy might suggest that the courts were persuaded by the Proponents’ reasoning. With the exception of one case, *E.F. Corp. v.*

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27 Kronman, supra note 2, at 127.
28 417 F.2d 1277 (9th Cir. 1969).
29 Id. at 1287.
every case has recognized the validity of floating liens in bankruptcy proceedings. This impression is misleading. While the courts were virtually unanimous in their support of floating liens, there was no consensus on which of the Proponents' arguments provided the conceptual buttress to the courts' rulings. The Entity Theory, the Substitution of Collateral Theory, and Judge Hufstedtler's interpretation of § 60(a) of the Bankruptcy Act each had their respective followings; however, even though Hufstedtler's rationale was the most often cited, there was no dominant rationale for the judicial acceptance of floating liens in bankruptcy proceedings.

What makes the division vicious and disturbing is that all three arguments are conceptually incompatible. At the core of the Entity Theory is the notion that the collateral is one item instead of a collection of items. Thus, the security interest transfers when the loan is originally made. In contrast, the Substitution of Collateral Theory depends on the conception of fluid assets as collections of items, the secured creditor providing additional consideration by assenting to the liquidation of each of the items. Consequently, the transaction is a stream of contemporaneous exchanges between the debtor and the secured creditor. Finally, Judge Hufstedtler's argument admits that fluid assets are collections of items, but still maintains that the security interest transfers from the debtor to the creditor at the time when the creditor originally distributes proceeds. A theory cannot simultaneously conceptualize the collateral as one and many items, nor can it conceive of the collateral as being transferred both at the point when the loan is originally made and when the last item in the fluid asset shifts. The Proponents' three strategies are not complements but exclusive alternatives.

The juxtaposition of a strong uniformity in the conclusion and a deep disparity in the reasoning surrounding floating liens in bankruptcy cases suggests that the courts were convinced of the correct result, but were not satisfied with any of the roads offered to that result. Perhaps the clearest indication of this situation is that several courts employed more than one of the strategies in defending floating liens. In *Grain Merchants of Indiana v. Union Bank & Savings Co.*, for example, the court relied on all three strategies in supporting a lien in accounts receivable. Advocating the Entity Theory, the court favorably stated: "From a business standpoint, the most accurate view of the transaction is to regard the stock of accounts

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31 496 F.2d 826 (10th Cir. 1974). For a discussion of the case, see Kronman, supra note 2, at 132 n.70.
32 Kronman, supra note 2, at 132.
33 Id. at 133.
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receivable together as an entity which was given as security for a new loan.\textsuperscript{35} Approving the Substitution of Collateral Theory, the same court, in the same decision, stated: "Here the newly arising accounts receivable may be considered as having been taken in exchange for the release of rights in earlier accounts and for a present consideration."\textsuperscript{36}

The court in \textit{Grain Merchants} made no attempt to reconcile, or even recognize, the incompatibilities between the two strategies.\textsuperscript{37} Indeed, it appears that none of the decisions attempted this. Rather, they would simply state one argument and then shift to another in an oblivious, perhaps willful, neglect of the incompatibilities between the different strategies.\textsuperscript{38} At best, this judicial behavior implies that the courts were undecided about which of the three strategies was most cogent. At worst, this judicial ambivalence indicates that the courts found none of the three strategies to be convincing. A review of the Proponents’ three strategies recommends the latter case.

D. \textit{Critique of the Proponents' Arguments}

Each of the Proponents’ arguments—the Entity Theory, the Substitution of Collateral Theory, and Judge Hufstedtler’s Theory—has significant shortcomings. An initial objection to the Entity Theory is that it appears to be a convenient legal fiction. By deeming that the fluid asset be treated as a single entity, the proponents of the Entity Theory seem to deem away the problem of the floating lien. The Transfer Intuition is the core of the Opponents’ position. Rather than deflect or refute this intuition, the Entity Theory seems to side-step the issue by defining the owned item (the fluid asset) in such a way that it encompasses what would normally be considered unowned elements (future components of the fluid asset). This begs the issue of why fluid assets should be considered single entities instead of collections of entities. The Entity Theory is innovative, but conceptually vacuous.

A response to this objection is to fill the void with common practice. As the court in \textit{Grain Merchants} observed, conceiving of fluid assets as individual items is not merely a convenient legal fiction but a convention in the business community.\textsuperscript{39} While this response deflects accusations that the Entity Theory is a contrivance, it has limited power to resolve the general debate because it answers a normative question with a positive

\textsuperscript{35} \textit{Grain Merchs.}, 408 F.2d at 215.
\textsuperscript{36} \textit{Id.} at 217.
\textsuperscript{37} \textit{Id.} at 214-17.
\textsuperscript{38} \textit{See, e.g.}, \textit{id.} at 214-17; \textit{In re King-Porter}, 446 F.2d3690 at 729-733; \textit{Rosenberg}, 262 F. Supp.
at 638-39.
\textsuperscript{39} \textit{Grain Merchs.}, 408 F.2d at 215.
point. This response effectively transforms the Entity Theory from a metaphysical manipulation into a brute assertion. Observing that common practice treats fluid assets as individual items is not the equivalent of simply defining fluid assets as single items, but it still begs the question of whether the law should adopt the perspective of the business community. While it is better than no response, a bare observation of business practice is a poor response to the Opponents’ argument that recognizing floating liens is equivalent to allowing debtors to grant interests in property they do not own. Filling the analytical void of the Entity Theory with common practice anchors the theory to reality, but it does little to improve the conceptual persuasiveness of the theory.

A deeper flaw in a strategy based on the Entity Theory is that it does not resolve the debate as much as it recharacterizes it. An implicit assumption in the Opponents’ original argument is that the initial transaction between the debtor and creditor (where the debtor grants the creditor a security interest in the fluid asset) involves the conventional understanding of the fluid asset as a collection of present items. The Entity Theory alters this hypothetical by redefining the content of a fluid asset. If fluid assets encompass not only the present items but also future items, then there are no additional transactions to animate the Opponents’ objection. However, the Opponents may simply shift their argument and object that bankruptcy proceedings should not recognize the debtor’s original security interest because it involves the debtor transferring rights in property it does not yet own. Conceiving of fluid assets as single items facilitates a one-transaction transfer, but it also challenges the integrity and legal possibility of the single transaction. The Entity Theory merely moves the focus of the debate from the subsequent transfers to the original transfer by building the subsequent transfers into the original transfer. It does not address the key issue of how the debtor conveys rights in property it does not yet own.

Although, unlike the Entity Theory, the Substitution of Collateral Theory is analytically potent, it also suffers from significant flaws. The creditor’s surrender of rights in the old collateral in exchange for rights in the new collateral saves the transfer from being preferential not because it is defined or conceived to do so but because it prevents the transfer from being on account of an antecedent debt. Unfortunately, like the Entity Theory, the Substitution of Collateral Theory seems to be an invented legal fiction. First, there is no communication between the debtor and the creditor or any other empirical indication of these transactions. The Opponents stand on equal footing in denying these exchanges as the Proponents do in proposing such exchanges. Second, there is no guarantee of a correspondence between rights surrendered and rights transferred, nor is a framework provided to cope with this problem. The theory seems to
suggest that if the debtor only acquired additional inventory after a perfected security agreement, then the creditor would not have any rights in the inventory until the debtor disposed of at least one item of inventory. More importantly, the theory does not explain the situation when a debtor acquires many additional units of inventory and disposes of only one unit. Either the creditor trades the rights in the one unit for the rights in the many units or the creditor only has rights in one of the new units.

Furthermore, whereas business practice supports the Entity Theory, business expectations seem to contradict the Substitution of Collateral Theory. Ideally, creditors lend to a financially healthy corporation or a corporation that they expect will eventually be financially healthy. One of the indicators of a healthy corporation is flux in its fluid assets. For example, a firm with a completely static inventory would not be considered healthy because it is neither selling nor producing and, therefore, is not generating any revenue. Thus, creditors receive security interests in fluid assets understanding, indeed hoping, that the contents of the fluid assets will quickly change. This expectation is inconsistent with the idea that secured creditors would simultaneously hold residual rights pertaining to the individual items in the fluid asset. At the very least, a reasonable conceptualization of the situation is that secured creditors assent beforehand to allow the debtor freedom of disposition of the items in the fluid asset. Because the secured creditor’s consent was either not required at all or granted beforehand, it would not be available as consideration when the fluid asset changes.

Finally, despite its popularity, there are flaws with Judge Hufstedler’s argument for floating liens. Perhaps the best explanation for the popularity of Judge Hufstedler’s strategy is its technical rigor. Read literally, § 60(a) of the Bankruptcy Act supports the interpretation that Judge Hufstedler proposed. This provides a legal haven for the judicial conviction in the validity of floating liens in bankruptcy without resort to metaphysical manipulations or imputed transactions.

The solution’s formal focus, however, also proves to be its greatest detractor. First, Judge Hufstedler’s reading of § 60(a) lacks the intuitive appeal of the Opponents’ analysis. One of the foundations of the Opponents’ argument is section 9-203(1) of the UCC, which is an expression of the Transfer Intuition. Far from expressing an intuition, the strict reading of § 60(a) is intuitively neutral, at best. Whereas most individuals readily agree to the idea that a person cannot grant rights in property she does not own, there is no common intuition concerning the content of “so far perfected.” The power of this objection is limited, but

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it does suggest that the response employing § 60(a) is more a technical haven rather than a robust response.

Second, a related objection is that employing a literal reading of § 60(a) may diffuse the formal elements of the Opponents' analysis, but it leaves the normative aspects intact. The Transfer Intuition normatively charges the Opponents' analysis, and if the Transfer Intuition is accepted, then it seems that floating liens must be rejected in bankruptcy proceedings. A literal reading of § 60(a) exploits the exact terms of the section (that no other creditor can have superior priority to the original creditor) to undercut the Opponents' analysis, but it provides no conceptual context for the reading. The strategy delineates a method by which judges can recognize floating liens in bankruptcy proceedings, but provides no guidance on why judges should recognize floating liens in bankruptcy proceedings. By leaving the reading of § 60(a) analytically bare, Judge Hufstedler permits the possibility that her interpretation is legally correct but normatively wrong.

A review of the cases simultaneously employing several of the Proponents' strategies suggests that the courts understood this deficiency in Judge Hufstedler's solution. While courts have combined the Entity Theory and a literal reading of § 60(a),42 the Substitution of Collateral Theory and a literal reading of § 60(a),43 and all three of the Proponents' theories,44 there do not appear to be cases where courts rely on only the Entity Theory and Substitution of Collateral Theory. This pattern indicates that the courts realized the analytical shortcomings of Judge Hufstedler's strategy and attempted to supplement the strategy with the conceptualizations provided by the Entity Theory or the Substitution of Collateral Theory so as to make Judge Hufstedler's interpretation of § 60(a) consistent with the Transfer Intuition. Unfortunately, the three strategies are mutually exclusive. More importantly, the discussed limitations of the Entity and Substitution of Collateral Theories severely limit their effectiveness as analytical girders for the § 60(a) strategy, even if the theories could somehow be conceptually reconciled.

E. Critique of the Opponents' Argument

Stripped of its formal component, the Opponents' argument translates into a policy objection against recognizing floating liens in bankruptcy proceedings based on deference to the Transfer Intuition. Floating liens involve subsequent transfers of additions to the fluid asset. As stated

43 See, e.g., In re King-Porter Co., 446 F.2d at 729-33.
44 See, e.g., Grain Merchs., 408 F.2d at 214-17.
earlier, if subsequent transfers are made within four months\(^4\) (or three months under the new Code\(^6\)) of the bankruptcy petition, these transfers are preferential. In order to avoid a preference, the debtor must be allowed somehow to transfer rights in assets it does not own, violating the Transfer Intuition. Thus, if the law is to be consistent with the Transfer Intuition, it should not recognize floating liens in bankruptcy proceedings.

Applying the Opponents' analysis to a normal lien, however, illustrates an essential flaw in the argument. Assume a debtor secures a five-year loan by granting a creditor a security interest in a machine. Every day, the debtor maintains the machine through services from its staff. Six months after the debtor acquires the loan, it becomes insolvent. After six additional months, the debtor petitions for bankruptcy. By preventing or slowing the decay of the machine, the maintenance services contribute to part or all of the value of the machine. Part of the physical machine may be chemicals used in servicing the machine (e.g., oils for the gears, and residual cleaning solution). Assuming that the debtor had not yet employed the staff and purchased the chemicals, the debtor did not own the services or the chemicals at the time when it transferred the security interest to the creditor. By the logic of the Opponents' argument, the security interest should not be recognized in a bankruptcy proceeding because doing so would violate the Transfer Intuition. The debtor pledged property (in this case, the chemicals and labor used in servicing the machine) that it did not own at the inception of the loan. At the very least, the Opponents' argument compels discounting the value of all secured assets by the value of the maintenance on those assets.

A more extreme example further emphasizes this flaw in the Opponents' strategy. Assume that a debtor firm takes a five-year loan and secures the loan with a lien on one of its cars. Six months after taking the loan, the debtor becomes insolvent. Eight months after the debtor takes the loan, the car encounters weekly problems so that the debtor must continually repair it. Within four months of the problems' onset, the debtor has incrementally replaced every part of the car. One year after the date of the loan, the debtor petitions for bankruptcy. Under either of the mentioned alternatives (denying a security interest altogether or decreasing for new value added), the Opponents' argument requires that the court not recognize any value in the secured creditors' lien on the car. Either the lien is not valid at all or the lien is valid only for parts not added in the preferential period, which in this example, excludes all parts of the car.

The examples above show that the Opponents' argument proves too much. Accepted at face value, the Opponents' argument affects virtually


every security interest, not just floating liens, because nearly every type of
security interest involves the debtor transferring rights in something not
yet owned, whether it is labor for maintenance or parts for the repair of
property. Following the logical consequences of the Opponents' analysis
leads to two equally undesirable consequences. First, if the liens were
simply voided, then courts would recognize only a fraction of liens in
bankruptcy proceedings. Only those liens encumbering property that does
not require maintenance or repair would be considered legitimate. Second,
in the alternative, courts would have to decrease the value of the lien by
the amount contributed by the debtor during the preferential period. From
an ex post perspective, this requirement would be extremely costly, as
courts would have to determine the portion of the value of the property due
to maintenance and repairs in the last four (or three) months. From an ex
ante perspective, this requirement would significantly increase the risks
and transaction costs associated with any lien. Secured creditors would
have to discount the value of the property by the amount they anticipate
the court would subtract. The confluence of these increased transaction
costs would either substantially decrease or eliminate the use of security
interests altogether.

An initial response to this objection would be to argue that physical
assets and fluid assets are sufficiently different so as to avoid this
conclusion. The examples provided entail maintenance of a piece of
property, whereas floating liens involve the disposition and acquisition of
items in a collection of entities. The Transfer Intuition forbids a debtor
from granting property it does not own, but it does not forbid a debtor
from agreeing to maintain property it does own. Floating liens fall into the
former category and should therefore not be recognized in bankruptcy
proceedings while normal liens fall into the latter category.

This response is essentially a reflection of the Entity Theory, and it
shares that theory's shortcomings. The response seems to deem away the
problem by conveniently categorizing certain aggregates of parts, such as
cars and machines, as units of property while classifying other aggregates
of parts, such as inventories or accounts receivable, as collections. There
is, however, no economic difference between the two classes. Both require
constant inputs and both have values that fluctuate. Moreover, common
practice does not distinguish the two. As advocates of the Entity Theory
argue, inventories and accounts receivable are usually considered single
entities from a business perspective. The response therefore hinges on a
system of individuation that has no economic or practical grip.

47 Grain Merchs., 408 F.2d at 215.
A New Perspective on Liens

Aiming the Opponents' argument at normal liens illustrates that most assets are like fluid assets in several important respects. First, most assets are subject to a flow of inputs and outputs. This flow is obvious in the case of fluid assets such as inventories and accounts receivable because the inputs and outputs are readily identifiable discrete units. Although not as prominently, many other assets are also subject to a flow. This might take the form of daily maintenance, where the output would be the disarray or deterioration of the asset and the input would be cleaning or even merely inspecting the asset. A more obvious analogy would be routine repair, where the output comprises the parts that must be replaced and the input is new parts. Economically, all of these flows are equivalent in the sense that all the outputs decrease the value of the asset, and all the inputs increase the value of the asset at a cost to the debtor.

Second, most assets are subject to endogenous ebbs in value. Although shifts in the supply or demand for goods can cause the value of all assets to fluctuate, a commonly purported point of distinction between fluid and static assets is that the value of fluid assets is also affected by their very use. For example, use of inventory is depletion of inventory, thereby causing a decrease in value. But this difference does not hold. Use of most assets also causes their depletion. As economists have long recognized with the concept of depreciation, every time a machine is employed it decreases in value because of wear and tear. In both cases, then, the debtor can decrease value through use or, conversely, increase value by investing costly inputs into the asset. Economically, there is no difference between the endogenous ebbs in the value of fluid assets and static assets.

The last, and perhaps least apparent, similarity between fluid assets and other assets is that both are subject to strategic manipulation by debtors. All courts and the Bankruptcy Code recognize that fluid assets are subject to strategic behavior by debtors because a debtor may "feed the lien" or inflate the value of a specific creditor's floating lien by increasing the value of the collateral. Material assets are also subject to this form of behavior. For example, consider a situation where a debtor has two secured creditors, one of which has a lien on a car and the other has a lien on a machine. If the debtor wishes to favor one creditor over the other, it can fail to maintain the car while perfectly maintaining the machine. While not as prominent, the effect is identical to that of feeding the lien because the debtor is advantaging one creditor at the cost of another by shifting resources between the two encumbered properties.
II. A Revised Jurisprudential Analysis of Transactions Involving Fluid Assets

The Proponents of floating liens would benefit from a thorough adoption of Heraclitus’s philosophy. Heraclitus argued that all objects are in constant flux, and he did not limit the concept of a dynamic entity to a special class of items. 48 Given the fundamental similarities between “normal” assets and fluid assets, a Heraclitean perspective on all property is appropriate in discussing liens in the bankruptcy context. Treating all assets as Heraclitean Rivers is not a reconceptualization but an accurate conceptualization of assets. The traditional static concept of assets cannot accommodate many common and important dimensions of assets, such as deterioration and maintenance. Treating all assets as fluid assets brings the Bankruptcy Code into conceptual congruence with these economic realities.

Although the historic debate over floating liens fails to provide a compelling basis for differentiating between static and fluid assets, this does not mean that judicial and academic caution surrounding floating liens is unjustified. In this Part, I propose to reconceptualize the distinction between fluid and static assets by focusing on how each category of assets is unified rather than whether each category of assets is unified. This perspective illustrates that the jurisprudential difficulties involved in regulating floating liens originate in the obscure nature of their principles of individuation. I employ this insight to explain the contours of the historic debate surrounding floating liens and to delineate the basic challenges involved in policing floating liens. Essentially, the complexity and obscurity of the unities of fluid assets make them ideal vehicles for abusive behavior on the eve of bankruptcy.

A. Principles of Individuation

Perhaps the greatest factor that has limited scholastic and judicial thought on floating liens is an unexamined reliance on common concepts of individuation. A key factor in common notions of individuation is spatial cohesion or organization. Individuals are more likely to consider an object as a single entity if it is spatially united than if it is spatially scattered. For example, a collection of car parts scattered across the floor of a workshop would be considered a multitude, not a unified whole. The same collection of parts, arranged into a car, would be considered as one.

48 See CHARLES H. KAHN, THE ART AND THOUGHT OF HERACLITUS: AN EDITION OF THE FRAGMENTS WITH TRANSLATION AND COMMENTARY 53 (1979) ("One cannot step twice into the same river, nor can one grasp any mortal substance in a stable condition, but it scatters and again gathers; it forms and dissolves, and approaches and departs.")
entity. Applying this idea to liens explains why scholars and judges have struggled with the apparently fluid nature of some assets. Traditionally, static assets were conceived as wholes because the parts were joined or arranged by some design, lending them a sense of cohesion. The common fixation towards spatial cohesion masked the dynamic nature of the assets. Even though judges and scholars understood that most assets required some form of maintenance, they did not characterize this as adding new value or pledging rights to unowned property. In maintaining and repairing static assets, debtors convey additional economic value to creditors, but the economic value is not manifested in a spatially cohesive form. An emphasis on spatial cohesion overwhelms the Transfer Intuition.

Traditionally, fluid assets were conceived as collections because the individual parts were not joined or arranged into some design. More importantly, the individual parts themselves were considered wholes. Without the illusion of unity provided by spatial cohesion, the flux in these assets was readily apparent to judges and scholars. Because the parts were considered individuals, the flux in parts was characterized as a constant shift in the collateral. Unlike the case with traditionally static assets, there was no spatial unity in the aggregate to deflect the Transfer Intuition, and the spatial unity in the parts fed the Transfer Intuition. Common reliance on spatial cohesion as a principle of individuation caused judges and scholars to characterize subsequent transfers of economic value in the case of fluid assets as subsequent transfers of collateral while ignoring identical transfers of economic value in the case of static assets.

A crucial distinction between fluid assets and static assets lies in the types of principles of individuation unifying each category. Fluid assets do not derive their unity from common principles of individuation, such as spatial cohesion. Fluid assets, such as inventory and accounts receivable, are specific to the commercial context, and they cannot be unified on the same principles behind common notions of unity. First, fluid assets are not spatially cohesive. Inventory is a collection of items that are spatially separate. Second, fluid assets are independent of spatial design. Inventory does not need to be arranged in any specific spatial pattern to be recognized as inventory.

Instead of spatial qualities, fluid assets derive their cohesion from other traits. A common unifying trait is business function. For example, a set of goods qualifies as inventory because all the parts share the basic function of serving as inputs of production or sale. Also, a set of payments qualifies as accounts receivable because they all serve the function of compensating the firm for its product. An entire corporation could be considered a fluid asset, in which case the principle of individuation would be the relevant corporate laws and charters that delineate the scope of the corporation. The commercial origin of fluid assets provides them with a
much broader, perhaps limitless, set of unifying principles, which permits enterprising professionals to create unities from virtually any set of goods.

The open nature of fluid assets' principles of individuation does not undermine the integrity of fluid assets' unities. The notion of unity, at least as used in describing common physical objects, is artificial in the sense that it lacks any deep metaphysical or economic grounds. In these respects, all principles of individuation are equally artificial. The attribute that distinguishes different principles of individuation is their ability to delineate the boundaries of the unity, that is, how well they define the individual. This is significant in a commercial and legal context, because it allows economic actors and courts to precisely define those entities that are the subjects of their transactions and, thus, to determine the terms of contracts. From this perspective, common principles of individuation hold little if any advantage over fluid assets' principles of individuation. For example, state corporate law defines the scope of a corporation just as well as common definitions delineate what should be considered part of a car. In terms of principles of individuation, fluid assets stand on equal footing to static assets.

B. Ramifications of a Heraclitean Approach to Collateral

The thoroughly Heraclitean nature of most assets suggests that the Transfer Intuition must be refined. As explained earlier, a strict application of the Transfer Intuition prohibits a debtor from transferring rights in any property it does not own at the time of the formation of the security agreement. Given that most liens entail subsequent transfers to creditors through maintenance and repair or replenishment of the collateral, a strict application of the Transfer Intuition would void almost every lien.

An examination of its intended scope provides guidance in refining the Transfer Intuition. The appeal of the Transfer Intuition stems from the basic idea that an individual cannot give something that she does not own. Thus, the Transfer Intuition is meant to address the problem of debtors pledging completely fictional assets. For example, the Transfer Intuition bars a debtor who does not own a car from pledging an automobile as collateral for a secured loan. Pledging rights in fictional collateral and


50 Although this Article addresses liens in the context of bankruptcy proceedings, these observations also impact the conceptualization and treatment of liens outside of the bankruptcy context. For example, § 9-203 of the UCC stipulates that a debtor must have rights in the property that it pledges in a security agreement. U.C.C. § 9-203(b)(2) (1999). In order to facilitate most liens, this part of the UCC must be refined in a manner similar to that suggested for the Transfer Intuition.
pledging rights in future maintenance of collateral both involve granting rights in unowned property.

The point of distinction is that, in the latter case, the pledge replaces collateral once owned by the debtor whereas in the former case, the pledge does not serve to replenish the collateral. A lien on most property entails an implicit or explicit agreement between the debtor and creditor allowing the debtor to not only retain possession of the collateral, but also use the collateral. By employing the collateral, the debtor diminishes the value of the collateral, and the creditor expects (often explicitly stipulates) that the debtor compensate for this diminution through maintenance and repair. By using the collateral, the debtor is essentially retaking some of the value in the rights that it transferred to the secured creditor. By maintaining the collateral, the debtor is returning the value that it took while using the collateral. In contrast, when a debtor pledges rights in fictional collateral, it is not maintaining the value of the creditor’s security interest but defrauding the creditor of value. This distinction also applies to the problem of feeding the lien with respect to fluid assets. Restoring inventory or other fluid assets to their proper level\textsuperscript{51} is the equivalent of restoring the value of the fluid asset. Yet, augmenting a fluid asset beyond its proper level is analogous to pledging a purely fictional asset, because the debtor did not have a surplus of the fluid asset at the point of the original secured loan nor (excepting explicit covenants) could the original loan be understood as an agreement for the debtor to maintain surplus levels of fluid assets.

Returning to the root intuition behind the Transfer Intuition, the auxiliary pledge to maintain collateral contained in most security agreements does not involve a debtor giving something that it does not have. The debtor possesses the collateral at the time it creates the lien, but in using the collateral, the debtor subsequently takes away portions of it. Rather than granting something it does not have, maintenance is equivalent to the debtor ensuring that it grants exactly what it had at the point in time when the lien was created. Thus, in refining the Transfer Intuition to accommodate the dynamic nature of most assets, the objective is to reformulate the Transfer Intuition so pledges of unowned property serving a restorative function are permitted while those not serving a restorative function are barred.

A “Revised Transfer Intuition” states that a debtor cannot pledge rights in property it does not own unless the unowned property serves to replace value consumed by the debtor’s use of pledged collateral. The requirement that subsequent transfers replace value consumed by the

\textsuperscript{51} The exact meaning of “proper level” for a fluid asset is at the core of the problems associated with encumbering fluid assets and will be addressed in Section II.D.
debtor not only captures the recuperative nature of the subsequent transfers, but also requires a causal link between the decrease in value and the debtor’s employment of the property. This additional requirement blocks the possibility of strategic behavior by the debtor. For example, a secured creditor may have collateral that has decreased in value for exogenous reasons (e.g., a decrease in market demand). If the debtor desires to favor the secured creditor, it may augment the value of the asset by restoring the asset to mint condition or, if it is a fluid asset, by increasing the size of the asset. The causal link requirement bars this behavior because the debtor did not cause the decrease in value.

Returning to the original dichotomy between maintenance and pledging completely fictional assets, the Revised Transfer Intuition accommodates the former but bars the latter. In pledging to maintain the collateral, the debtor is pledging rights in unowned property, but since unowned property will only be employed to restore value the debtor consumes by using the pledged collateral, this does not offend the Revised Transfer Intuition. On the other hand, a debtor pledging completely fictional property transfers rights in unowned property that neither restores the value of pledged property nor restores the debtor’s consumption of the collateral. The Revised Transfer Intuition encompasses the intended scope of the original Transfer Intuition while also accommodating the inherent dynamism of most liens.

At least in terms of temporal dynamics, the Revised Transfer Intuition simplifies the conceptual treatment of fluid assets. Under the original Transfer Intuition, both section 9-203 of the UCC and § 547(c) of the Bankruptcy Code pose problems for the recognition of fluid assets in bankruptcy proceedings. Section 9-203 of the UCC states that a debtor must have rights in the collateral to perfect a security interest. Lest the vast majority of security interests be barred from perfection, section 9-203 of the UCC should incorporate the Revised Transfer Intuition. This allows static assets to be perfected under section 9-203 of the UCC, even though most security interests involving static assets implicitly or explicitly involve collateral to which the debtor has no rights at the time of perfection. This also allows fluid assets to be perfected at the time of the original loan, instead of the point at which the last item is received, because subsequent additions to the fluid asset do not offend the Revised Transfer Intuition as long as they replenish the fluid asset only from the debtor’s use of it.

Section 547 of the Bankruptcy Code addresses preferential transfers. Under the original Transfer Intuition, replenishments of fluid assets were

considered subsequent transfers because they could not have been transferred at the time of the original loan. Again, unless most static liens are to involve preferential transfers because of maintenance and repair on the eve of bankruptcy, § 547(c) must incorporate the Revised Transfer Intuition. The Revised Transfer Intuition saves repair and maintenance on the eve of bankruptcy from being preferential because it allows the debtor to transfer these recuperative subsequent transfers at the time of the original loan.

By allowing this logic for static assets, the Revised Transfer Intuition also disarms § 547 of the Bankruptcy Code with respect to fluid assets. Subsequent replenishments of inventories and accounts receivable are also transferred at the time of the original loan; therefore, they cannot be preferential transfers. Incorporating the Revised Transfer Intuition into the Bankruptcy Code and relevant laws formally recognizes that there is no distinction between fluid and static assets. Therefore, timing conventions employed with static assets can be simply transplanted to the case of fluid assets.

C. Revisiting the Classical Debate on Floating Liens in Bankruptcy

In light of the dynamic nature of all assets, the classic debate between the Opponents and Proponents of floating liens in bankruptcy proceedings is a red herring. First, the Opponents' challenge to the floating lien is misguided. The Opponents advocate non-recognition of floating liens in bankruptcy proceedings because they entail debtors transferring rights in assets they do not own. However, all liens involve debtors transferring rights in assets they do not own. Accepted prima facie, the Opponents’ argument is a move to void all liens, not only floating liens. Dynamism is not a point of distinction between floating liens and normal liens.

Second, the Proponents contribute to the misdirection by responding to the Opponents’ challenge instead of delineating its fundamental error. Beyond their specific shortcomings, all of the Proponents’ strategies to defend the validity of floating liens in bankruptcy proceedings are critically defective because they answer the wrong question. The dynamism of fluid assets is not problematic. All assets are dynamic. In attempting to conceptualize floating liens so that they are like liens on static assets or sets of liens of static assets, the Proponents address a fictional concern.

Finally, Judge Hufstedler’s interpretation of § 60(a) eked out the correct conclusion—that the Bankruptcy Act considers floating liens perfected at the time of the original loan—but for the wrong reasons. Floating liens are not perfected because no other secured creditor has a higher priority, but because the debtor had already transferred rights in the
after-acquired collateral at the time of the original loan. Indeed, perhaps the gravest consequence of Judge Hufstedler’s strategy was that its strict formalism contributed to the Proponents’ neglect of the deep conceptual flaws in the very question posed by the Opponents.

While it dismantles the classic debate, the Heraclitean approach to collateral explains the appeal of the Entity Theory and the Substitution of Collateral Theory. The analogy of the Entity Theory is correct, but the Proponents argued in the wrong direction. Instead of arguing that fluid assets are like static assets, they should have argued that static assets are like fluid assets. Since economic realities dictate a comparison of static assets to fluid assets, this flaw made the Entity Theory fatally vacuous. The dynamic nature of most assets also provides substance to the common business intuition that inventory and accounts receivable should be considered as a single entity. The reason why these fluid assets were considered collections was because of the apparent flux in each asset. If all assets experience some dynamism, like inventories and accounts receivable (at least from a purely economic perspective), then this distinction evaporates. Again, the analogy is correct but the direction is wrong. Professionals correctly consider inventories and accounts receivable as single entities not because they could be considered static in some sense, but because all single entities are dynamic in some sense.

A Heraclitean conception of collateral also unpacks some of the implicit qualities of the Substitution of Collateral Theory. One of the virtues of all liens is that the debtor can simultaneously employ a single asset as both a working asset and collateral. An implicit, and sometimes explicit, condition of these concurrent uses is that the debtor maintains the value of the collateral. The creditor allows the debtor to decrease the value of its security interest by using the collateral on the condition that the debtor replenishes consumed value by maintaining or repairing the collateral. Fluid assets provide a salient manifestation of this agreement because the depletion and replenishment of the collateral occurs through the sale and purchase of what are commonly considered individual items. The Substitution of Collateral Theory is a formalization of this understanding between secured creditors and debtors. The Substitution of Collateral Theory attempts to leverage this implicit agreement (at least in the case of fluid assets) to impute additional consideration between creditors and debtors. Although this argument encounters several important defects, a Heraclitean notion of assets explains its attractiveness. Scholars and judges may have been prone to accept the notion of an underlying agreement between the debtor and creditor concerning use of collateral in the case of fluid assets because they realized that the same scenario obtains in the case of static assets. A Heraclitean perspective illuminates the debtor’s implicit right to deplete the property and its duty
Getting the Question Right on Floating Liens and Securitized Assets

to replenish the collateral—the analytical substratum of the Substitution of Collateral Theory.

D. The Actual Problem with Floating Liens

The identical conceptual mechanics of fluid and static assets demonstrates that the classic debate between Proponents and Opponents of floating liens is misguided, but it does not illustrate that the concern surrounding floating liens in bankruptcy proceedings was unfounded. Fluid and static assets may both be dynamic, but fluid assets experience a much greater depth of change than static assets. More importantly, because fluid assets are not unified according to common principles of individuation, they are subject to unique types of changes. These differences create possibilities for strategic behavior that the law should address.

Perhaps the most obvious difference between the dynamics of fluid assets and static assets is the depth of change in each type of asset. While creditors and debtors implicitly realize that static assets involve subsequent transfers of value from the debtor, these subsequent transfers are usually marginal in relation to the value of the collateral. The costs of maintaining and repairing property normally constitute only a fraction of the value of the property. Though it is theoretically possible that a debtor completely replaces every part of a machine, this rarely occurs in practice. In contrast, debtors and creditors enter floating lien agreements expecting the fluid asset to be completely depleted and replenished multiple times over the life of the debt. Because the solvency of a business may depend on the turnover of inventory, a creditor would be alarmed if the inventory of a debtor were stagnant. Whereas static assets involve implicit and subdued changes in value, fluid assets hinge on radical shifts in value.

A subtler, but more important, distinction between static and fluid assets is the nature of the change. Use and maintenance will cause the value of static assets to fluctuate independently of exogenous market factors. However, abstracting from exogenous effects, the value of a static asset gravitates around a certain downward trend because of irreparable decreases in value due to use. For example, daily use of a tractor will decrease its value. A certain portion of this deterioration may be repaired, but another portion is forever lost. The maintenance and reparable damage to the tractor cause the fluctuations in its value while the irreparable damage creates the downward trend. Like static assets, fluid assets encounter fluctuations in their value. The value of a firm’s inventory decreases as the firm exhausts the inventory and increases as new inventory arrives. Unlike static assets, the value of fluid assets has no trend, even abstracting from exogenous market factors. If a business is
growing, its inventory may grow to meet greater demand. But if a business shrinks, the inventory may shrink as well. Moreover, the trend for inventory and other fluid assets is not as clear and simple as a correlation to business size. The total value of a firm's fluid assets may radically shift according to changes in the nature of its business, changes in supply chain paradigms, and a myriad of other causes. This imbues fluid assets with a wider latitude of change than static assets.

The different types of principles of individuation that define static and fluid assets account for this difference in the volatility of the assets. Common notions of unity define static assets, which rely on spatial cohesion or spatial patterns. For example, an anvil is a mass of iron that fills a specific shape, and a car is an aggregate of parts assembled in a particular pattern. While this does not limit a static asset to a specific set of parts (thus, the same car can have different tires), it does create limitations in terms of either a physical schema (i.e., a certain collection of parts) or physical dimensions. These physical criteria define a static asset independently of the use of the asset or the nature of the firm employing the asset. In contrast, fluid assets arise as financially convenient entities. Thus, their principles of individuation derive from the business functions that they serve, and not from spatial cohesion or a certain arrangement of their parts. Fluid assets are therefore defined as a collection of goods providing the basic components of a company's trade. The function-based nature of fluid assets makes the content of fluid assets wholly dependent on the nature of the firm employing the asset. While it is possible to concretely define an automobile without reference to a particular entity owning the automobile, the exact content of inventory is inconceivable divorced from a company.

An initial possibility, based on these differences, for the actual problem with floating liens in bankruptcy proceedings is their dynamic content. While both fluid assets and static assets are dynamic in the sense that they entail subsequent transfers of value, the content of static assets is fixed while the content of fluid assets is volatile. More importantly, this difference raises suspicions of abuse. If the content of fluid assets is volatile, creditors holding floating liens may receive windfall gains as the debtor's business expands. The possibility of intentional abuse is more alarming. Debtors could collude with secured creditors to adjust the content in order to reallocate value among creditors. While promising, this theory is incomplete because the volatility of the content of fluid assets is a conceptual divergence from static assets with negligible economic effects. While the content of static assets is not volatile, the value of static assets is

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54 The term "business size" is itself subject to multiple interpretations, such as sales or total assets.
volatile. Exogenous shocks in market supply and demand can cause the value of static assets to change dramatically over time. Thus, the value of fluid assets and static assets are both dynamic, even though the content of static assets is inert. Additionally, shifts in the content of fluid assets should be considered as exogenous, rather than endogenous, effects. Changes in the contents of fluid assets arise from changes in the underlying business. While the security agreement between the debtor and the creditor may regulate the debtor’s business operation in several respects, it leaves the debtor basically free to operate the business according to its own designs.55 Thus, most changes in the content of fluid assets are not generated by the security agreement but are reactions to external forces such as expansion or contraction of the business or shifts in management models. Consequently, not only are fluid assets and static assets both economically volatile, but they are that way because of exogenous factors. Therefore, the conceptual difference between fluid assets and static assets has very little economic bite.

The claim that volatility in the contents of fluid assets may provide secured creditors with windfall gains also ignores the commercial context of most secured transactions. First, secured creditors reap the possibility of over-security or full-security when the content of fluid assets increases, but they also confront the risk of being under-secured because of a decrease in the content of fluid assets. Moreover, the downside risk eclipses the upside risk. The maximum amount a secured creditor may claim from a debtor is the value of the loan. If proceeds from a sale of collateral generate a surplus, the secured creditor must return the surplus to the debtor.56 This caps the secured creditor’s positive-state return at the value of the debt. On the other hand, there is no floor to the secured creditor’s downside risk. Theoretically, the content of the encumbered asset may decrease to a zero value, leaving the secured creditor with no secured source for reclaiming its debt (although it may still proceed against the debtor as an unsecured creditor). The volatility of fluid assets proves to be more a liability than a boon to secured creditors.

Of course, a secured creditor may contract around the negative effects of volatility in fluid assets. For example, a secured creditor may require that a debtor maintain a certain level of inventory regardless of business conditions and stipulate that failure to maintain that level is an instance of default. Yet, by the same logic, a debtor may also negotiate around an over-secured lien. For example, if the content of a fluid asset expands significantly beyond an original secured loan, the debtor may employ the

55 This assumes that the security agreement does not intentionally attempt to exploit the volatility in the content of fluid assets—an important possibility that I will address shortly. See infra pp. 28-32.
excess value as collateral for additional funds from the secured creditor. Alternatively, the debtor may negotiate with another creditor for a new secured loan that more accurately reflects the value of collateral. Part of the proceeds from this loan would then be used to settle the debt with the original secured creditor. The context of secured transactions usually involves sophisticated parties who can negotiate and renegotiate contracts to their mutual advantage. This suggests that if the content of fluid assets changes so as to exceed the value of the encumbering loan, the debtor and secured creditor will most likely devise a means of exploiting the increased collateral.

Even if it is assumed that shifts in the content of fluid assets do provide windfall gains to secured creditors, this does not necessarily merit a ban on recognizing floating liens in bankruptcy. As discussed, both fluid and static assets may fluctuate in value because of exogenous shocks. Even given their fluctuations in value, liens on static assets are still recognized in bankruptcy proceedings. Consequently, variance in value alone is not a sufficient ground for barring floating liens.

An alternative basis for objecting to floating liens is that their fluctuations, at least those due to shifts in the content of the lien, may prejudice other secured creditors or general creditors. For example, increasing the content of a floating lien, even for purely legitimate reasons, decreases the claims of unsecured creditors because it effectively transforms some of the firm’s assets into the fluid asset. This objection ignores the notice requirements in the UCC. To be perfected, any lien must be filed with the proper authorities. This filing requirement provides notice to other parties that a secured creditor potentially encumbers a certain set of property. Consequently, a secured creditor with a properly perfected floating lien provides notice to all creditors that a fluid asset is encumbered. And again, since most creditors are sophisticated actors that can be assumed to be knowledgeable about the dynamics of a fluid asset, secured creditors and unsecured creditors lending to a debtor with an encumbered fluid asset realize the possible contingencies. More importantly, they incorporate the negative possibilities into the interest rate of the loan. Assuming sophisticated creditors, the unique dynamism of fluid assets is not problematic, at least for legitimate shifts in the content of the fluid assets.

The final and most serious objection to floating liens arising from their unique dynamism is the potential for intentional abuse by the debtor. The debtor may intentionally increase or decrease the content of a fluid asset in order to favor or punish a secured creditor. For example, the value

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of a secured creditor's security interest in a debtor's inventory may have decreased below the value of the loan because of exogenous market shifts. In this situation, a debtor may artificially increase the size of the inventory (artificially, meaning that the only reason for the change is to favor the secured creditor) in order to increase the value of the secured creditor's security interest. If the debtor has other creditors, this biases the secured creditor at their expense because it transforms some of the pool of resources that would otherwise be available for their benefit into the collateral for the secured creditor.

Again, a reference to liens on static assets provides a response to this objection. Static and fluid assets are both dynamic in the sense that they both involve subsequent transfers of value between the debtor and the creditor. As a consequence, this makes both types of assets, not only fluid assets, possible instruments for strategic behavior. For instance, if a debtor desired to favor a secured creditor with a security interest on a tractor, the debtor could devote significant resources to ensure that the tractor remains in mint condition. This would effectively draw resources available to general creditors into the ambit of the creditor's security interest. Though this response ignores the significant differences between fluid and static assets, it does illustrate the important point that floating liens cannot be disregarded in bankruptcy purely on the grounds that they are susceptible to strategic behavior. The naked potential for strategic behavior does not generate enough conceptual difference between static assets and fluid assets to justify barring one while recognizing the other.

What this suggests instead is that some traits of fluid assets make them uniquely suitable for strategic behavior, and this is the true problem plaguing the validity of floating liens in bankruptcy proceedings. To understand the unique opportunities for abuse presented by floating liens, it is necessary to understand the consequences of the different type of principle of individuation at the heart of fluid assets.

Because static assets derive their content from common principles of individuation, common experience provides a concrete foundation for understanding the content of most static assets. In contrast, the business-oriented nature of fluid assets alienates them from the benefits of common experience. For example, most individuals would understand that a car remains the same car if you change a tire, but it becomes a different car if you upgrade the engine and change the chassis. In contrast, the content of fluid assets is not governed by common principles of individuation, but by common business practices. As a result, many people have no intuitive idea of what the content of a fluid asset should be. For example, given the profile of a company, most individuals would not have an instant idea of the appropriate value of the company's inventory. Indeed, even most economic scholars or financial analysts would not be confident in an
estimate of an appropriate value or range of values for any given company’s inventory. While life experience hardens and refines notions of static assets, it leaves the content of fluid assets obscure at best.

The relative complexity of fluid assets exacerbates the problems created by their conceptual opacity. Common principles of individuation are based on spatial cohesion or spatial patterns, which creates a transparency in the content of static assets. An individual only has to measure a static asset or check for a list of parts to determine that it has the correct content. In contrast, the unity of fluid assets emanates from the businesses employing the assets. The unity is a nexus of a myriad of business considerations. This obfuscates the content of fluid assets not only because the factors that contribute to the asset are potentially very numerous, but also because many of the factors are opaque. The appropriate value for a company’s inventory is not only related to many different aspects of the company, but many of these aspects (such as the company’s business model, its supply paradigm, and its management chain) are not readily ascertainable.

The conceptual alienation of fluid assets directly impacts their legal treatment because it undermines judicial and scholastic confidence in the ability of the courts to police fluid assets. A debtor will sometimes desire to favor a secured creditor over other secured creditors or general creditors, and one of the means of facilitating this favoritism is to transfer value into assets encumbered by the secured creditor’s security interest. As discussed, not all transfers of value to a secured creditor’s assets are abusive. If the transfer is recuperative and linked to the debtor’s depletion of the asset, then the transfer is a legitimate maintenance of collateral. But fluid assets are better vehicles for strategic behavior because they offer debtors a less risky method of transferring value between creditors.

First, there is a lower chance of detection. If a debtor attempts to favor a secured creditor by augmenting a static asset, other creditors would likely detect this abuse because most individuals have a relatively clear notion of the content of static assets. More importantly, since the content is independent of the nature of the company, the debtor does not have a device to obfuscate the content of the static asset. A subtler form of favoritism would be to increase repairs and maintenance of the static asset. Yet, this alternative also encounters significant obstacles. First, the opportunities are limited. A debtor can only maintain or repair a piece of property to the extent that it employs the property. Second, the magnitude is also limited. Repair and maintenance can augment the value of property, but only to a constrictive upper limit—the value of the collateral in mint condition. Aside from inherent limitations, increased repair and augmentation might still be detectable. If the debtor has possessed the collateral for a length of time, it has established a maintenance history.
Arguably, because the maintenance history delineates a particular level of maintenance, deviation from that level would suggest the debtor’s abusive intentions.

In contrast, favoring a secured creditor by augmenting the value of a fluid asset is much less susceptible to detection. Both the alien nature of a fluid asset and its complexity create great uncertainty concerning its appropriate value. An increase in the value of inventory could just as likely be caused by a shift in demand for the firm’s products or a change in the firm’s supply system as it could be motivated by a debtor’s attempts to favor certain creditors. Without a strong grasp on the multiple aspects of the firm’s business, creditors are at the mercy of firm management. Additionally, the volatility of fluid assets liberates them from the value-constraints present in the case of static assets. While an enormous change in inventory may arouse suspicion, the value of a fluid asset is not confined by a physical schema or a value ceiling. As an abusive device, fluid assets offer greater opportunities at lower risks.

Second, even if strategic behavior is detected, it is much more difficult to prove in the case of fluid assets than in the case of static assets. For the same reason that creditors would find it easier to detect strategic behavior with static assets over fluid assets, judges would be able to confirm strategic behavior more easily in the case of static assets. Life experience would provide judges with a deep resource for determining the appropriate content of a static asset while it would provide little if any guidance in determining the content of fluid assets. In order to determine the appropriate content of a fluid asset, the judge must consider the debtor’s business, whereas the content of static assets is completely independent of the debtor’s business. More importantly, the tight relationship between the debtor’s business and the content of the fluid asset multiplies the issues at litigation. While with static assets the issues at litigation are limited to the physical schema of the asset, fluid assets are sensitive to a myriad of business considerations. This provides the debtor with a galaxy of scenarios and explanations from which to mount a defense. Aside from the greater opportunity of victory, this affords the debtor significant leverage in settlement proceedings. Finally, bankruptcy often operates in a time-sensitive context. Fluid assets provide the debtor with ammunition for delay tactics by raising an abundance of potentially relevant issues.

E. Revisiting Judicial Responses to the Floating Lien

A noteworthy trait of many of the judicial opinions grappling with the validity of floating liens in bankruptcy proceedings is the division between the formal arguments and the practical arguments in favor of floating liens.
For example, the court in *Grain Merchants* deployed all three of the Proponents’ strategies in attempting to formally justify the recognition of the floating lien.\(^5^9\) The court then buttressed its defense of the floating lien by noting that the debtor and creditor did not exploit the floating lien for preferential purposes.\(^6^0\) The same phenomenon occurs in the *DuBay* opinion. After defending the validity of floating liens with a purely formalistic rationale,\(^6^1\) Judge Hufstedler immediately comments that a further reason for supporting the floating lien in the instant case is that it was not employed to transfer wealth from other creditors to the secured creditor.\(^6^2\) This reliance on analytically separate practical and formal considerations in supporting floating liens permeates most cases recognizing floating liens in bankruptcy.\(^6^3\)

The bifurcated defense of floating liens suggests several interesting dimensions of the courts’ approach to floating liens. Initially, it indicates that the courts perceived two possible shortcomings in floating liens. The first shortcoming is a lack of jurisprudential basis. The courts needed to reconcile the recognition of floating liens in light of existing statutory and common law doctrines. The second shortcoming is the possibility of strategic behavior. The courts were concerned with two possibilities. First, the courts were concerned that the floating lien was the equivalent of a secret lien in the sense that other creditors did not know about the nature of the underlying collateral.\(^6^4\) Second, they were concerned about the problem of feeding the lien, that the debtor was preferentially inflating the value of the fluid asset underlying the floating lien on the eve of bankruptcy.\(^6^5\)

Perhaps the most significant ramification of this bifurcated defense of floating liens is that it illustrates that the courts (whether they were fully cognizant of this point or not) understood that the debate between the Proponents and Opponents was disconnected from the real concerns at issue. If the debate impounded the real issues at stake, settling the argument between the Proponents and Opponents would have been sufficient to affirm the validity of floating liens. However, after running through the formal gauntlet presented by the Opponents, the courts consistently proceeded to buttress their formal analysis with economic analyses, arguing that recognizing the floating lien did not produce economically perverse results.

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\(^5^9\) *Grain Merchs. of Ind. v. Union Bank & Sav. Co.*, 408 F.2d 209, 214-17 (7th Cir. 1969).
\(^6^0\) *Id.* at 217.
\(^6^2\) *Id.* at 1289.
\(^6^4\) *Grain Merchs.*, 408 F.2d at 217.
\(^6^5\) *DuBay*, 417 F.2d at 1289.
In light of the dynamic content of fluid assets and its consequences for the ability of courts to police floating liens, the courts' formal and practical concerns are all misguided. The basic dynamics of fluid assets are identical to those of static assets. Thus, both assets should have roughly similar legal status. The principle of individuation of fluid assets originates from business practice. Consequently, the perfection of a floating lien should be sufficient to alert all business parties of the volatility of floating liens and its possible consequences. Finally, the key economic issue with floating liens is not the problem of "feeding the lien." This problem plagues both floating liens and normal liens. Rather, the actual problem with floating liens is that they are especially ideal vehicles for the strategy of feeding the lien. The law should be sensitive to this aspect of floating liens, not merely to the point that they can be intentionally inflated.

A virtue of the thoroughly Heraclitean approach to liens is that it unifies the judicial problems of floating liens into one problem that incorporates both formal and economic elements. Indeed, the courts' bifurcated approach could be understood as an attempt to grapple with this single problem, but within the non-Heraclitean paradigm of assets. The formal arguments for the validity of the floating lien can be understood as the courts' attempt to grapple with the different principle of individuation working in fluid assets. The concern regarding proper notice to other creditors captures the alien nature of fluid assets' principle of individuation, which causes a lack of common understanding of the concept of the fluid asset (meriting the courts' caution). Finally, the courts' concern regarding the possibility of feeding the lien might be understood as a recognition of the fact that fluid assets are more suitable for this form of strategic behavior than normal assets. It is important to note that a non-Heraclitean notion of static assets does not allow the strategy of feeding the lien with these assets. Thus, the courts' recognition of this abuse for floating liens only translates to a perception of the heightened risks associated with floating liens.

III. Revising the Bankruptcy Code's Treatment of Preferential Liens

In light of the jurisprudential progress in Parts I and II, this Part proposes two strategies for revising the Bankruptcy Code. On a general level, the Revised Transfer Intuition can be transparently integrated into the current language of the Bankruptcy Code. This provides a unified treatment of all liens. Focusing on the specific problem of feeding the lien, I discuss the deficiencies in § 547(e) of the Bankruptcy Code (which represents the current approach to detecting and policing this form of strategic behavior), review several suggestions for improving § 547(e) and
propose a new method for identifying and preventing pre-bankruptcy manipulation of assets—the Matrix Test.

A. Section 547 of the Bankruptcy Code

As discussed earlier, the Bankruptcy Code permits a trustee of a bankruptcy estate to avoid a "preferential" transfer of property between an insolvent debtor and a creditor. Section 547 of the Bankruptcy Code provides five conditions for a transfer to be preferential. The transfer must be "to or for the benefit of a creditor," and the transfer must be made while the debtor is insolvent. The transfer must be on account of an antecedent debt. If the creditor was an insider at the time of the transfer, the transfer must occur within one year of the date of the filing of the bankruptcy petition. Otherwise, the transfer must be made within ninety days of the petition. Finally, the transfer must enable the creditor to receive more than it would under a Chapter 7 liquidation had the transfer not been made. Implicitly working in § 547 of the Bankruptcy Code is the traditional, or non-Heraclitean, concept of entities. This is evidenced by § 547(c)(5), which creates an exception for floating liens on inventory and accounts receivable. If the Bankruptcy Code incorporated a dynamic concept of assets, then floating liens would not be preferential per se. The necessity of excepting a subclass of floating liens illustrates that a static conception of assets underlies the law.

The intended target for § 547 of the Bankruptcy Code is a debtor's manipulation of its assets so as to intentionally or unintentionally favor a certain creditor. For example, a debtor may become insolvent but desire to maintain the good will of a secured creditor in order to facilitate future transactions (perhaps if the debtor intends to reorganize). If the secured creditor's security interest under-secures the loan, then the debtor desires to improve the secured creditor's position by granting it rights in additional collateral. If the transfer is made within ninety days of the bankruptcy petition (assuming that the creditor is not an insider), the five criteria of § 547 perfectly capture this scenario. The transfer of rights in additional collateral benefits the secured creditor, is made while the debtor

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66 Infra, Sections I.A-B.
68 Id. § 547(b)(1).
69 Id. § 547(b)(3).
70 Id. § 547(b)(2).
71 Id. § 547(b)(4).
72 Id.
73 Id. § 547(b)(5).
74 Id. § 547(c)(5).
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is insolvent, is made on account of an antecedent debt, and improves the creditor’s financial situation.

Section 547 sweeps most perfected security interests into its ambit because it does not incorporate the Heraclitean concept of assets. As previously argued,\textsuperscript{75} almost every security interest involves subsequent transfers of rights in property from a debtor to a creditor because a debtor must maintain and repair encumbered equipment or replenish fluid assets. If these activities occur within ninety days of a petition for bankruptcy, the transfers are voidable. This result would either significantly increase the transaction costs associated with all forms of secured debt or make these arrangements completely unworkable. More importantly, the drafters of the Bankruptcy Code did not intend to create such a broad and powerful obstruction to secured financing.\textsuperscript{76} Therefore, § 547 should incorporate or be interpreted to incorporate the Heraclitean concept of assets.

Section 547 represents the Bankruptcy Code’s attempt at grappling with the classic debate concerning the validity of floating liens in bankruptcy. The five-factor test of § 547 effectively makes most, if not all, floating liens involve some amount of preferential transfers. The trustee can avoid all additions to an encumbered fluid asset within ninety days of the bankruptcy petition.\textsuperscript{77} Given this categorical prohibition against floating liens, § 547(c)(5) carves out a large exception by explicitly exempting floating liens involving inventory and accounts receivable.\textsuperscript{78} Thus, the Bankruptcy Code’s approach to floating liens is a very rough compromise—barring all floating liens except the two largest categories.

The drafters of the Bankruptcy Code realized that recognizing some types of floating liens in bankruptcy proceedings raised the issue of how bankruptcy courts would cope with the problem of feeding the lien. Since § 547(c)(5) exempts subsequent transfers of value from the debtor and creditor when they occur in liens on inventories and accounts receivable, debtors would be able to favor secured creditors holding these types of liens at the cost of other creditors. Section 547(c)(5) employs a Two-Point Net Improvement Test to counter the possibility of this species of strategic behavior. First, the value of the lien is determined at ninety days from the petition for bankruptcy ($V_1$). If the creditor is fully secured or over-secured ninety days before bankruptcy, then nothing in the interim is considered.\textsuperscript{79} If the creditor is under-secured ninety days before bankruptcy, any change in its position must be determined. The value of the floating lien is determined on the day of the petition for bankruptcy

\textsuperscript{75} See supra, Part I.
\textsuperscript{78} Id. § 547(c)(5).
\textsuperscript{79} Id.
(V₂). If V₂ is greater than V₁ (if the secured creditor’s position has improved), then the additional value is considered preferential and therefore avoidable by the bankruptcy trustee. 80 If V₂ is less than V₁, the court makes no adjustment. 81 Essentially, the Two-Point Net Improvement Test is a manifestation of the ninety-day (or one-year) requirement of § 547(b), tailored to the specific details of floating liens.

Aside from the problems posed by the Bankruptcy Code’s reliance on the traditional notion of assets, two structural elements of the Bankruptcy Code’s treatment of preferences merit consideration. First, the rough, piecemeal treatment of floating liens indicates ambivalence on the part of the drafters concerning floating liens. The general application of § 547(b) suggests that the drafters are against recognizing floating liens while the exception presented by § 547(c)(5) demonstrates that the drafters limited this doctrinal position in recognition of the usefulness of two types of floating liens. The crude way in which the drafters reconciled these competing interests also indicates an analytical depravity in the draf ter’s approach to floating liens. Essentially, the drafters seem to be in the same position as the courts considering floating liens. They knew that floating liens should be recognized in some instances, but they lacked a sound conceptual basis to guide their implementation of this conviction.

Second, the ninety-day period requirement in §§ 547(b)(4)(A) and 547(c)(5) is also a conceptually uninspired compromise on the part of the drafters. 82 Understood with the requirement that the debtor be insolvent, the ninety-day period requirement is an attempt on the part of the drafters to identify transfers from the debtor that are intended to shift value from other creditors to a favored creditor in a bankruptcy proceeding. The ninety-day period is meant to capture the stretch of time when bankruptcy is sufficiently eminent that the debtor can prepare for bankruptcy. The set nature of the period creates both ex post and ex ante problems for the effectiveness of the test. From an ex post perspective, the test is not sensitive to individual circumstances and therefore is both over-inclusive and under-inclusive. From an ex ante perspective, sophisticated parties can easily undermine the standard because of its static nature. Not only does this decrease the effectiveness of the test, it also increases the transaction costs of secured financing because parties’ behavior will be distorted to overcome the test.

80 Id.
81 Id.
82 The focus of this Article is on fluid assets, so I will focus the discussion on the ninety-day requirement as it applies to floating liens. However, similar arguments apply to normal liens, as the underlying collateral types are both dynamic.
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B. Incorporating the Revised Transfer Intuition into § 547

Interpreting § 547 of the Bankruptcy Code in light of the thoroughly Heraclitean nature of assets and the Revised Transfer Intuition resolves these problems with the Bankruptcy Code’s treatment of preferences. First, imputing the Revised Transfer Intuition into § 547 creates compatibility between the section and the vast majority of liens. Second, the dynamic nature of all assets provides an analytical substratum that creates an elegant solution to the drafter’s ambivalence towards floating liens. Finally, understanding the differences between the concepts of individuation working in fluid assets and static assets provides a better apparatus to identify strategic behavior on the part of the debtor on the eve of bankruptcy.

Section 547 of the Bankruptcy Code attempts to counter the problem of strategic behavior by the debtor on the eve of bankruptcy by allowing the trustee to avoid transfers that improve the situations of specific creditors on the eve of bankruptcy. 83 This strategy is sensible for inert assets.

Yet, almost every asset is dynamic. As a consequence, the security interest between the debtor and creditor involves a stream of additional transfers, where the debtor depletes the creditor’s interests by using the collateral and then replenishes the interest by repairing or maintaining the collateral. This additional layer of transactions contradicts the drafters’ fundamental assumption that subsequent transfers that increase the value of the creditor’s interests are strategically motivated or duplicate strategic behavior. The dynamism of static assets introduces an innocuous class of subsequent, recuperative transfers, which do not worsen the position of other creditors. In extending loans, other creditors recognized that the debtor would maintain encumbered property. They realized that these transfers would occur and adjusted the terms of the relationship accordingly. Thus, the debtor has already compensated other creditors for these transfers.

In light of the dynamism of static assets, the original strategy in § 547 is too blunt because it cannot differentiate between abusive and recuperative transfers on the eve of bankruptcy. A recuperative transfer maintains the value of the creditor’s collateral whereas an abusive transfer grants the creditor more collateral. Yet, both types of transfers improve the creditor’s position in the sense that the creditor would have been worse off without the transfer. Both types of transfer are on account of an antecedent debt because the creditor does not provide any new consideration to the debtor. If maintenance is explicitly specified in a security agreement, then

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the creditor may foreclose on a lapse of maintenance, but the decision not to foreclose is not additional consideration. Thus, the terms of § 547 capture both abusive and recuperative transfers, when they should apply only to the former.

A simple and transparent manner of improving § 547 of the Bankruptcy Code so as to allow it to distinguish between abusive and recuperative transfers is to impute the Revised Transfer Intuition into the Bankruptcy Code. The Revised Transfer Intuition bars a debtor from pledging rights in unowned property unless the unowned property serves to replace value consumed by the debtor while employing pledged collateral. Incorporating the Revised Transfer Intuition into the Bankruptcy Code transforms the initial transaction between the debtor and creditor. The debtor pledges not only the collateral but also subsequent transfers that serve to replace value consumed by the debtor in employing the collateral. Maintenance and repair of collateral do not constitute a subsequent transfer because the debtor transferred this stream of transfers along with the original collateral at the time of the original loan. Since maintenance and repair were transferred at the time of the original loan, they are not on account of an antecedent debt. By incorporating subsequent transfers required by maintenance and repair into the original transfer of rights in the collateral to the creditor, the Revised Transfer Intuition permits § 547 to precisely target only strategic behavior in a universe of dynamic assets.

C. Floating Liens in a Revised § 547

The rough treatment of liens in § 547 is best understood as a compromise between theoretical concerns and empirical constraints. On the one hand, floating liens appear to involve, indeed require, preferential transfers from the debtor to the creditor on the eve of bankruptcy. A decade of academic debate had not provided a compelling theoretical basis for accepting floating liens as non-preferential. On the other hand, floating liens are a common and important form of secured financing. Often the only means of financing available to small and medium-sized firms are floating liens on inventory or accounts receivable. Voiding floating liens in bankruptcy proceedings would significantly increase the transaction costs of financing for this class of business. The drafters did not have a theory to sustain the practice, nor could they simply deny it. The compromise was to create a basic approach according to theory

84 See discussion supra Sections I.D-E.
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(stating that all floating liens are preferential per se), but then to force two of the most common floating liens—inventory and accounts receivable—into that theoretical framework.

Incorporating the Revised Transfer Intuition into § 547 renders § 547(c)(5) obsolete and provides a unified approach to all liens. To be commercially viable, virtually all security interests require the pledge of a stream of future recuperative transfers in addition to the collateral. A crucial aspect of security agreements is that they allow a single asset to serve as both an input for production as well as collateral for a loan. Not allowing the debtor to pledge a stream of recuperation along with the collateral would defeat this duality, undermining a key reason for the use of security interests. As applied to fluid assets, the Revised Transfer Intuition shields replenishments of the fluid assets from being preferential transfers, as long as they are recuperative. Thus, interpreting § 547 so as to accommodate liens on static assets accommodates liens on fluid assets as well. Section 547(c)(5) becomes obsolete because all floating liens are not preferential per se but are preferential only if they involve non-recuperative transfers on the eve of bankruptcy. There is no need to exempt two species of floating liens when all floating liens are non-preferential.

The debate between the Proponents and Opponents failed to provide a compelling basis for treating liens on fluid assets as if they were liens on inert assets because all assets are dynamic. Imputing the Revised Transfer Intuition into § 547 provides a conceptual framework for accommodating floating liens not by reducing fluid assets to inert assets but by recognizing the dynamism in all assets and the transfer of rights in assets. This creates a consistent approach to all species of floating liens—they are all acceptable. More importantly, this creates a consistent approach for liens on fluid assets and liens on static assets. In both cases, the Revised Transfer Intuition saves subsequent transfers from being preferential by distinguishing between recuperative and non-recuperative transfers.

D. Ex Post Deficiencies in the Two-Point Net Improvement Test

Imputing the Refined Transfer Intuition into § 547 of the Bankruptcy Code may create a conceptually consistent treatment of all liens, but it does not address the residual problem of policing liens. Understanding the

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87 Id. § 547(c)(5).
88 Because both static and fluid assets are dynamic, both are subject to strategic behavior by the debtor. This Article focuses on fluid assets in the bankruptcy context, since they are better candidates for strategic behavior. Therefore, the discussion will focus only on the use of fluid assets by debtors to favor certain secured creditors.
shortcomings of the current method of policing floating liens provides insights into a better approach.

Section 547(c)(5) of the Bankruptcy Code employs a Two-Point Net Improvement Test to defeat attempts by debtors to employ floating liens to favor certain secured creditors on the eve of bankruptcy. Scholars have attacked three aspects of this test.\footnote{Kronman, supra note 2, at 141-50; Note, Trustees Do It Better: Analyzing Section 547(c)(5) of the Bankruptcy Code, 105 Harv. L. Rev. 1285, 1290-98 (1992).} First, § 547(c)(5) waives the Two-Point Net Improvement Test if the secured creditor is over-secured or fully secured ninety days before the bankruptcy petition. Second, the test only considers the creditor’s position at two points, ignoring all transactions between the two points. Third, the test simply moves the initial point of consideration to one year before the bankruptcy petition if the creditor is an insider. Individually and together, these three aspects of the Two-Point Net Improvement Test make it both over-inclusive and under-inclusive.

First, waiving the application of the Two-Point Net Improvement Test when a secured creditor is over-secured or fully secured ninety days before the bankruptcy petition makes § 547(c)(5) under-inclusive.\footnote{Note, supra note 89, at 1291-92.} This rule effectively grants a creditor or debtor full freedom to employ abusive strategies in the case that the value of the collateral happens to exceed the value of the debt ninety days from the bankruptcy petition. For example, assume that a secured creditor has a floating lien on a debtor’s inventory. The lien is fully secured ninety days from the debtor’s petition for bankruptcy (the inventory is worth $100). Ten days before the bankruptcy petition, the creditor discovers that the debtor has dramatically decreased its inventory in response to a downturn in business. The creditor compels the debtor to restore the value of inventory to the full value of the debt. This is a paradigm case of the exploitative behavior that § 547(c)(5) was enacted to prevent. The secured creditor dramatically improves its position on the eve of bankruptcy at the cost of other creditors. Yet, § 547(c)(5) prevents the trustee from avoiding this transfer. Since the secured creditor was fully secured ninety days before bankruptcy, the Two-Point Net Improvement Test does not apply to it. (See Figure 1.)

The ninety-day period employed by the Two-Point Net Improvement Test is an approximation of the period when the drafters of the Bankruptcy Code believed that abusive strategies would likely begin. An apparent rationale in excluding cases where the secured creditor is fully secured at the beginning of this period is that the secured creditor would have no reason to employ abusive strategies if it is already secure. However, this logic ignores the dynamic content of fluid assets. The content of fluid assets may react to changes in business conditions, creating a deficiency in
Since the Secured Creditor is fully secured ninety days before the Debtor’s bankruptcy, the abrupt and dramatic increase in the value of the liened fluid asset is immune from attack by the bankruptcy trustee.

The protection provided by the fluid asset. Indeed, on the eve of bankruptcy, it is not only likely that the content of fluid assets such as inventory would change, but that it would also change to the detriment of the secured creditor.91 This provides a secured creditor with ample reasons to engage in abusive behavior even if it is fully secured ninety days before the bankruptcy petition. The ninety-day assumption counsels against considering fluctuations earlier than ninety days before the bankruptcy petition, but it does not support ignoring fluctuations within the ninety-day period in the case that the secured creditor was initially fully secured. In light of the dynamic content of fluid assets, all augmentations of fluid assets within the ninety-day period are potentially preferential.

The cyclicality of some fluid assets suggests a subtler problem with the exemption for fully secured creditors. Some forms of fluid assets fluctuate in constant patterns. For example, in most seasonal industries, the volume of inventory and accounts receivable fluctuate dramatically, but on a regular basis.92 The value of floating liens on these cyclical fluid assets is best considered as an average of the cycles. This creates the possibility that

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92 Kronman, supra note 2, at 146.
a creditor may be over-secured in a shallow or illusory manner. If the secured creditor’s status is considered only at the high-point of the cycle, then the secured creditor may appear to be fully secured or over-secured, when the secured creditor is actually under-secured for much of the remainder of the cycle. In cases where the beginning of the ninety-day period coincides with a peak of a cycle, a secured creditor may be fully secured or over secured; however, the mean value of the fluid asset may make the secured creditor under-secured. Section 547(c)(5) would nonetheless exempt such a creditor from the Two-Point Net Improvement Test, thus allowing the creditor to fraudulently increase the value of its security interest with impunity. (See Figure 2.)

**Figure 2**

![Cyclical Under-Inclusiveness](image)

If the ninety-day period before the Debtor’s bankruptcy occurs at the peak of a cyclical fluid asset’s sequence, then the Two-Point Net Improvement Test provides an inflated figure for the value of the security interest on such fluid asset and immunizes later strategic behavior, such as the sudden increase in the value of the fluid asset on the eve of bankruptcy.

Even in cases where the secured creditor is under-secured at the beginning of the ninety-day period, the Two-Point Net Improvement Test does not permit the trustee to avoid many instances of preferential transfers. The Two-Point Net Improvement Test only permits a trustee to avoid augmentations in the encumbered fluid asset to the extent that the augmentations improve the secured creditor’s position vis-à-vis his state at the beginning of the ninety-day period. There is no attention to transactions between the two points or the state of the fluid collateral...
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between the two points. If, for example, the content of the fluid collateral decreases in the ninety-day period, the creditor may compel the debtor to restore it to the value at the beginning of the ninety-day period.

Assume that a secured creditor has a floating lien on a debtor's inventory that secures a $100 loan. At the beginning of the ninety-day period, the value of the inventory is $90, making the secured creditor under-secured by $10. Ten days before the bankruptcy petition, the value of the inventory is $50. The creditor compels the debtor to increase the value of the inventory to $90. This is another clear case of manipulative behavior by the secured creditor; however, § 547(c)(5) does not cover this transaction because the fraudulent transaction merely restores the inventory to its value at the beginning of the ninety-day period. (See Figure 3.)

Figure 3

The Two-Point Net Improvement Test only permits a trustee to avoid additions that increase the value of a liened fluid asset above its value ninety days before the debtor's bankruptcy. This immunizes strategic behavior by debtors and secured creditors on the eve of bankruptcy that only increases the value of a liened fluid asset up to such initial value.

The purpose of § 547(c)(5) is to detect and prevent strategic behavior between a debtor and a secured creditor on the eve of bankruptcy. This purpose suggests an emphasis on the individual transactions between the debtor and secured creditor or between the debtor and the encumbered collateral on the eve of bankruptcy. Yet, § 547(c)(5) employs a snapshot analysis that simply compares the secured creditor's status at two points.
This approach is ideal for the simpler question of whether the secured creditor has improved its position from the beginning of the ninety-day period to the bankruptcy petition. However, § 547(c)(5) is not concerned only with the change in the creditor’s position but with how that change comes about. The Two-Point Net Improvement Test is not sufficiently adroit to capture the target behavior of § 547(c)(5).

The cyclicality of some fluid assets raises the possibility that the Two-Point Net Improvement Test is not only under-inclusive but also over-inclusive. As discussed, the beginning of the ninety-day period may coincide with a cycle’s peak. This would provide an inflated value for the fluid asset, permitting significant under-inclusion. The inverse of this scenario creates the possibility that § 547(c)(5) is under-inclusive. If the beginning of the ninety-day period coincides with the nadir of a cycle, this would provide an artificially low value for the fluid asset. Through the natural and normal fluctuations in the fluid asset, the secured creditor’s position will improve after the beginning of the ninety-day period (as the fluid asset is cyclically restored). However, the trustee would be able to avoid all of these subsequent transfers, even though they were not related to manipulative behavior between the creditor and the debtor. (See Figure 4.)

**Figure 4**

The Two-Point Net Improvement Test is over-inclusive with respect to cyclical assets if the nadir of the sequence of the liened cyclical asset occurs ninety days before the debtor’s bankruptcy.
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The snapshot nature of the Two-Point Net Improvement Test creates a profound bias against § 547(c)(5)’s effectiveness in accurately detecting preferential transfers. Section 547(c)(5) only provides an accurate measure of the secured creditor’s true status if the beginning of the ninety-day period coincides with the mid-point of a cycle, a statistically unlikely event. Any other point artificially overstates or understates the secured creditor’s status. A longer cycle exacerbates this error by decreasing the chance that the mid-point of the cycle occurs at the beginning of the ninety-day period. A greater magnitude in the cycle also worsens the problem by exaggerating the distortion produced by a non-mid-point intersection. However, if secured creditors are repeat players, this problem in § 547(c)(5) is not a crippling impediment. The rule of large numbers ensures that the instances of over-inclusiveness and under-inclusiveness will counteract each other.

A common phenomenon—especially in the case of small or new business ventures—is that a secured creditor will not only encumber a debtor’s fluid assets, but also require an insider of the debtor to personally guarantee the loan. Insider guarantees raise concerns because encumbered insiders have both the motive and the ability to engage in abusive behavior on the eve of bankruptcy. By providing a personal guarantee to a secured creditor, an insider renders her personal property susceptible to claims by the secured creditor if the business’s collateral is insufficient to cover the debt. Thus, the insider has a strong incentive to ensure that the secured creditor is fully secured. Insiders have an intimate knowledge of the financial state of the company. Often, they may actually affect the financial decisions of the company. This means that insiders will often become aware of possibilities of bankruptcy quite early. They may alarm the secured creditor to independently act to protect the secured creditor’s interest well in advance of the ninety-day period.

In response to the difficulties presented by insider guarantees, § 547(c)(5)(A)(ii) states that the initial point in the Two-Point Net Improvement Test moves from ninety days before the petition for bankruptcy to one year before the petition for bankruptcy. The intent behind this shift was to lengthen the period encompassed by the Two-Point Net Improvement Test so as to counter the insider’s superior knowledge and power over the business’s operations. The shift, however, does not accomplish its intent. The shift in dates only means that the Two-Point Net Improvement Test compares the secured creditor’s state on the day one

93 Scott C. Barney, Comment, Bankruptcy Preferences and Insider Guarantees, 51 LA. L. REV. 1047, 1048 (1991); Note, supra note 89, at 1293.
94 Barney, supra note 93, at 1048; Note, supra note 89, at 1293.
95 Barney, supra note 93, at 1048-49; Note, supra note 89, at 1293-94.
year before the petition for bankruptcy to the day of the petition for bankruptcy instead of using the point ninety days before the petition as the initial point of reference. Like the original ninety-day test, if the creditor is fully secured at the initial point (now one year before the petition for bankruptcy), the two-point test is completely waived.

Furthermore, § 547(c)(5)(A)(ii) may facilitate rather than frustrate abusive behavior by insiders. Fluid assets such as inventory and accounts receivable tend to experience a downward trend close to the date of the bankruptcy petition. By shifting the first reference point to an earlier date, § 547(c)(5)(A)(ii) may inadvertently designate an early date of the downward trend or even a date before the downward trend occurs, thereby increasing the possibility that the creditor is fully secured at the initial reference point. More importantly, § 547 protects the creditor’s state at the initial reference point for the entire ensuing year. This is completely contrary to the purpose of the section because it enhances the insider’s ability for abusive behavior. Not only does the insider have earlier warning of possible financial downturns, but under § 547(c)(5)(A)(ii) it also has more time to implement abusive strategies. A perverse consequence of § 547(c)(5)(A)(ii) is that it may endow the secured creditor with a greater starting value and then provide it with protection against any preference attacks for an entire year.

E. Suggestions for Remedying the Deficiencies in § 547

The engine behind the cited problems in § 547(c)(5) is the snapshot nature of the Two-Point Net Improvement Test. By emphasizing only two parts of a continuum of debtor and creditor activity, the test is both over-inclusive and under-inclusive. Suggestions for improving the test follow two general themes. First, some scholars have argued that the test should move away from an aggregate approach and focus more on individual transactions. Second, other scholars have argued that the test should refine its aggregate approach to capture more of the intermediate activity. Both strategies solve some of the problems cited, and both strategies create additional problems.

The first suggestion is a two-prong analysis of transactions on the eve of bankruptcy. For all transactions in the ordinary course of business, the Two-Point Net Improvement Test applies.\(^{97}\) Transactions outside of the ordinary course of business would be open to fraudulent conveyance attacks by the bankruptcy trustee.\(^{98}\) This strategy resolves the problems with the snapshot approach of § 547 by empowering the bankruptcy

\(^{97}\) Note, supra note 89, at 1298.

\(^{98}\) Id.

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trustee to engage individual dubious transactions. With respect to transactions outside of the ordinary course of business, this test effectively creates an inclusive evaluation of the ninety-day (or one-year) pre-petition period. Even if the secured creditor is fully secured at the beginning of the pre-petition period, the trustee may still attack suspicious transactions outside of the ordinary course of business under the fraudulent conveyance doctrine. Simultaneously, this solution retains some of the administrative simplicity of the original § 547 approach by preserving the snapshot approach for transfers in the ordinary course of business. This strategy permits an administratively simple approach for cases that do not involve abusive behavior (where only transfers in the ordinary course of business apply) while providing the trustee with adequate means to avoid abusive behavior with a fraudulent conveyance approach for non-ordinary course of business transactions.

This strategy does not address all of § 547's shortcomings, and it creates additional problems as well. First, the most obvious flaw with this strategy is that it does not cope with the cyclicality of some fluid assets and the danger of over-inclusiveness that this presents. Assuming an extreme case, the beginning of the pre-petition period may coincide with the nadir of a cycle, and the petition may occur at the peak of the cycle. All transfers are in the ordinary course of business. Thus, the strategy employs a pure Two-Point Net Improvement Test. As a consequence, the trustee may avoid all transfers to the fluid asset in the pre-petition period, although the secured creditor should receive half of the value of the transfers. Furthermore, the strategy does not empower the secured creditor or the court with a means of addressing this error.

The strategy introduces a new problem to § 547 by relying on an “ordinary course of business” label to empower the trustee to deviate from the snapshot approach. As an initial point, the ordinary course of business distinction is a much more ambiguous concept than the two-point test. Its introduction would open the application of § 547 to additional litigation, as parties contest whether individual transactions were in the ordinary course of business. More importantly, § 547 applies to the period immediately preceding bankruptcy. Presumptively, firms in this period are insolvent or at least in a financially marginal condition. During this period, firms are much more likely to innovate or deviate from their normal routines, as measures to escape impending bankruptcy. Consequently, much of a firm’s behavior, if not the vast majority, would be non-routine. This corrupts the purity of the signal conveyed by behavior that is outside of the ordinary course of business. When a firm is healthy, transactions outside of the ordinary course of business merit suspicion because the normal operation of the firm does not require them. Yet, a firm threatened with insolvency or financial collapse must change its operations if it is to
survive. Consequently, the link between abnormal operations and strategic behavior is much more tenuous. This has two consequences for the operation of the proposed strategy. First, it promises to expand the litigation associated with the "ordinary course of business" clauses because the context of § 547 provides more events that fall in this category. Second, the context of § 547 undermines the effectiveness of the fraudulent conveyance doctrine in accurately preventing preferential transfers. The decisions of firms in financial crises are dramatically more opaque than the decisions of healthy firms. Consequently, the court is more likely to err in deciding whether particular transfers are fraudulent. The confluence of these disadvantages would create a substantial increase in the transaction costs of recovering secured floating debt in bankruptcy. Debtors would bear these increased costs through increased costs of capital.

The second possible strategy would be to increase the resolution of the two-point test instead of dividing § 547's test. Anthony Kronman recommends such a strategy and argues that § 547's Two-Point Net Improvement Test should incorporate a rebuttable presumption that the fluid asset deteriorates during the pre-petition period.99 If the creditor is fully secured at the beginning of the pre-petition period, the secured creditor's state is not open to attack by the trustee.100 If the creditor is not fully secured at the beginning of the pre-petition period, there is a presumption that all increases in the value of the fluid asset are due to abusive behavior.101 The rationale supporting this presumption is that fluid assets tend to decline in value because of business pressures on the eve of bankruptcy.102 The trustee would be able to rely on this presumption in avoiding subsequent transfers to the fluid asset; however, the secured creditor may overcome the presumption by providing evidence that the transfers were in the normal and anticipated course of the debtor's business.103

This strategy addresses the possibility of over-inclusiveness due to cyclicality by allowing the creditor to overcome the presumption of a downward trend. Cyclical fluctuations are normal and anticipated aspects of the debtor's business. Consequently, a secured creditor would be able to defend an increase in the value of a fluid asset by demonstrating that the fluid asset is subject to cyclical fluctuations and the beginning of the ninety-day period coincided with the nadir or a low point of the cycle.

99 Kronman, supra note 2, at 147-48.
100 Id. at 148.
101 Id.
103 Kronman, supra note 2, at 147.
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Unfortunately, the strategy is not an effective answer to the other defects in § 547. Kronman’s strategy does not alter § 547’s waiver of the Two-Point Net Improvement Test for fully secured creditors. If the creditor happens to be fully secured at the beginning of the pre-petition period, Kronman’s suggestion provides it with full freedom to engage in abusive behavior on the eve of bankruptcy. Transforming the assumption of abusive behavior into a presumption does nothing to counter the problem of under-inclusiveness created by cyclicality. The trustee does not have any power to pierce the illusion created by the juxtaposition of a cyclical peak and the beginning of the pre-petition period. Finally, Kronman’s approach still relies on a snapshot system for determining the amount of the preference and is therefore susceptible to intermediate abusive behavior by the debtors and creditors. A secured creditor may not improve its position vis-à-vis its status at the beginning of the pre-petition period, but still engage in abusive behavior in maintaining its status at the level of the initial reference point. Kronman’s system provides no manner for the trustee to detect or avoid such behavior.

Kronman’s approach also would increase litigation because it employs the “ordinary course of business” standard in order to cope with cyclical fluid assets. As argued, this standard is unclear at best, and the context of impending bankruptcy further obfuscates the application of the standard. Yet, every time that a secured creditor desires to rely on the cyclicality of a fluid asset to defend against a trustee’s avoidance power, it must demonstrate that the increase in the collateral was in the “ordinary course of business.” Under Kronman’s system, the benefits of reducing over-inclusiveness in § 547 are unavoidably tied to the costs of litigation.

A third strategy is to synthesize the two strategies by both re-focusing § 547 on individual transactions in certain cases and increasing the resolution of the Two-Point Net Improvement Test in other cases. Specifically, the third strategy would be to incorporate Kronman’s presumption into the “ordinary course of business” of the two-prong approach. This strategy would address all of the ex post defects in § 547. Empowering the trustee with fraudulent conveyance avoidance powers in non-ordinary course transactions counters the possibility of under-inclusiveness while reducing the assumption of abusive behavior into a presumption in the case of ordinary transactions addresses the problem of over-inclusiveness.

Merging the two strategies also combines the problems of the two strategies. The ambiguous nature of the “ordinary course of business” standard would still be present, increasing litigation. More importantly, the unique detractors of each strategy would be present as well. The trustee’s
use of the fraudulent conveyance doctrine to defeat transfers outside of the ordinary course of business would both increase the amount of litigation and be less effective because of the context of looming bankruptcy. The secured creditor’s ability to employ cyclicality as a defense would still be tied to mandatory litigation.

F. Ex Ante Deficiencies in the § 547 Test

The literature addressing § 547 of the Bankruptcy Code and the problem of feeding the lien focuses almost exclusively on the ex post perspective, in terms of delineating how well § 547 detects and deters abusive behavior. Given the commercial context in which most floating liens arise, an ex ante perspective seems more appropriate. Most secured creditors tend to be sophisticated actors who are repeat players. Therefore, it is not merely analytically convenient, but also empirically consistent, to assume that secured creditors will learn the governing law and adapt their behavior to exploit it. While this practice entails large transaction costs, secured creditors may spread these costs over many transactions, making informed rationality an efficient choice. The ex ante effects of § 547 are likely to overwhelm the ex post effects. Thus, the ex ante perspective merits careful consideration.

The ex ante counterpart to how well a provision deters unwanted behavior is how well the provision applies to the relevant parties. A provision may appear to perfectly capture undesired behavior from an ex post perspective, but it may actually be very ineffective if the parties can alter their behavior in reaction to the provision. In this respect, the discrete nature of the Two-Point Net Improvement Test makes § 547(c)(5) susceptible to ex ante avoidance by debtors and creditors. Specifically, the two points employed by § 547(c)(5) provide ideal references for strategic planning because they are static and easily identifiable.

Debtors and creditors can exploit the ex ante shortcomings of § 547 by either postponing the petition for bankruptcy or stockpiling the encumbered fluid asset in anticipation of a petition for bankruptcy. Knowing that the point ninety days before the petition for bankruptcy is the reference point for determining preferential transfers, debtors can postpone bankruptcy (thereby pushing the beginning of the pre-petition forward) while building the value of the floating lien. Assume that a debtor desires to favor a secured creditor with a floating lien on the debtor’s inventory. The floating lien secures a loan of $110. On January 2, the value of the debtor’s inventory is $50, which is substantially below the value of the debt. The debtor realizes that it is insolvent and decides to file for bankruptcy. In order to favor the secured creditor, the debtor will transfer resources to inventory, fully securing the creditor. Then, the
debtor will delay the petition for bankruptcy for ninety days, allowing the secured creditor to avoid a preference attack. This strategy is successful because the debtor knows exactly how long to wait in order to avoid a preference attack, and the test does not adjust to the debtor's behavior. (See Figure 5.)

**Figure 5**

The ex ante strategy of postponement involves the debtor increasing the value of the liened fluid asset to full-security and then waiting for the ninety-day period to expire. Again, the set nature of the time frame and the inertness of the test permit this type of abusive behavior.

The more likely form of strategic behavior is to simply maintain high levels of the fluid collateral if insolvency is on the horizon. Thus, if a debtor encounters financial difficulties, its first reaction will be to fortify its fluid assets. This saves the debtor the costs of rebuilding the fluid collateral in a weaker financial state and the uncertainty associated with remaining solvent for ninety days in order to avoid a preference attack. The most noticeable form of this strategy evidences a decline in the encumbered fluid asset, followed by an increase in value, and then a steady state until the petition for bankruptcy. (See Figure 6.)

The case of insider creditors frustrates the first type of ex ante evasion while enhancing the second. Assuming a downward trend in the value of the fluid asset, if the secured creditor is under-secured at the beginning of the pre-petition period (one year before the petition for bankruptcy), then the debtor must rebuild the value of the fluid asset and forestall the
bankruptcy petition for a year (after the creditor is fully-secured) in order to avoid a preference attack. While possible, this strategy is more difficult than delaying the bankruptcy petition for ninety days. Firms contemplating bankruptcy are almost always in financial distress, making replenishing a fluid asset and maintaining its value (while simultaneously fending off other creditors) for an entire year a difficult task. Yet, insider creditors need not worry about this contingency, because they can often secure themselves in anticipation of bankruptcy. Insiders have an intimate

**Figure 6**

![Ex Ante Strategy of Fortification](image)

If a debtor suspects that it may file bankruptcy, it may preemptively increase the value of a liened fluid asset in preparation for the possibility of bankruptcy.

knowledge of the company’s finances and business, increasing the time horizon of their assessments. Moreover, insiders can often directly affect the financing choices of a debtor. Thus, insiders can perceive possible risks of insolvency and build the value of the fluid asset in preparation. Cyclical fluid assets are subject to the same forms of ex ante manipulation. If the beginning of the pre-petition period coincides with the nadir of a cycle, a debtor can stall the petition for bankruptcy by postponing until the pre-petition period occurs at the peak of a cycle (all the while increasing the value of the fluid asset). The more likely scenario is that the debtor will artificially deviate from the cyclical nature of the volatile asset in preparation for the bankruptcy petition. In either case, the
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debtor can defeat the provisions of § 547 by planning around the timing of the Two-Point Net Improvement Test.

Empirical evidence supports, or at the very least does not contradict, the analytical point that § 547 is vulnerable to ex ante evasion. Writing in 1984, Thomas Ross made the striking observation that “section 547 has apparently to date never been used to avoid security interests in inventory or accounts receivable.”105 This trend has not changed. There have been only a handful of cases discussing the Two-Point Net Improvement Test, and they have addressed the issue of valuation of collateral.106 On the other hand, bankruptcy trustees have employed § 547 repeatedly to void unperfected security interests and judgment liens by unsecured creditors.107 Of course, this evidence is ambiguous. It is equally consistent with a theory that § 547 is creating perfect compliance. However, the theoretical opportunities for strategic behavior support transparent evasion instead of perfect compliance.

A second ex ante consideration is the distortionary effects of various regulations. Sophisticated actors will adjust their behavior in response to regulation. They may comply with the normative goals of a regulation, but recalibrate their activities so as to maximize gains given the new regulation. This produces costs to the actors (as their utility is lower)108 and therefore decreases the welfare of society. Supposedly, the pursuit or attainment of the normative goals eclipses this decrease in social welfare. In this case, the costs associated with compliance could be considered the price for the desired behavior. Alternatively, sophisticated actors may engage in evasive behavior. Actors will also incur costs, but the crucial difference is that the normative goals driving the regulation will not be attained. The costs associated with evasive behavior are deadweight losses because they produce no benefit from the original state either in terms of increased welfare to the actors (although they facilitate increased welfare in comparison to compliance) or the implementation of normative goals.

106 In re Ebbler Furniture & Appliances, Inc., 804 F.2d 87, 88 (7th Cir. 1986); In re Missionary Baptist Found. of Am., Inc., 796 F.2d 752, 761 (5th Cir. 1986); Note, supra note 89, at 1291.
107 Ross, supra note 105, at 51-54.
108 This assumes that actors behave in a fashion that maximizes their welfare given the legal constraints imposed. Thus, actors would have maximized their welfare before the imposition of the new legislation. The new legislation was enacted because the previous behavior was somehow not acceptable, and it is aimed at altering the actors’ behavior. Assuming a single optimal point, this alteration leads to a decrease in utility. Assuming multiple optimal points, this alteration leads to either decreased utility or the same level of utility (if the regulation merely moves the actors between optimal points). The only manner in which regulation could increase utility would be if it addresses a coordination problem, where the individual agents could not coordinate to achieve an ideal outcome. Section 547 does not address a coordination problem. Rather, preferences are, by definition, a transfer of wealth from one or more creditors to another set of creditors.
These considerations lead to a two-level evaluation of the distortionary effects of any regulation. First, a regulation should create as little opportunity for evasion as possible, therefore limiting the number of transaction costs that are deadweight losses. Second, the regulation should create low transaction costs—the price of compliance or evasion should be as low as possible. As argued, § 547 is very vulnerable to evasive behavior. It does not fare well in the second stage of the analysis either. Both ex ante strategies in avoiding preferential attacks under § 547 involve high costs. An insolvent firm petitioning for bankruptcy has the option of liquidation or reorganization. Ideally, a firm should file for Chapter 7 if its liquidation value exceeds its value as a going concern, and a firm should file for Chapter 11 if its liquidation value is less than its value as a going concern. If a firm should be liquidated, its resources are better committed to other enterprises, and every month that it continues as an entity entails a sub-optimal allocation of resources. This point is the first cost associated with employing a postponement strategy in avoiding preferential attacks under § 547(c). If the debtor delays a petition for Chapter 7 to protect a favored creditor’s position, it prolongs an inefficient allocation of resources. Depending on the disparity between the values of liquidation and reorganization, this cost can be substantial.

The second source of costs is common to both the strategy of postponement and accumulation in light of Chapter 7. Normally, a fluid asset serves as both a functional business asset and collateral. When a debtor fortifies a fluid asset in anticipation of bankruptcy, the additions to the fluid asset serve no business purpose. Indeed, the additions to the fluid asset must not serve a business purpose, lest their use deplete the value of the fluid asset. Consequently, § 547(c) gives debtors an incentive to misallocate resources on the eve of bankruptcy. Again, depending on the value of the secured debt, the costs associated with this misallocation can be substantial.

In the case of a firm filing for Chapter 11, accumulation of a fluid asset in anticipation of bankruptcy is also costly in terms of being an inefficient allocation of resources. Even though the firm will not be liquidated, the additions to the fluid asset must nonetheless remain unused in order to reinforce the secured creditor’s position. Because a firm filing for Chapter 11 is an efficient nexus of resources (at least under idealized circumstances), the postponement strategy does not have the costs of perpetuating an inefficient collection of resources. Yet, the postponement strategy does pose the additional cost of threatening the viability of the firm as a going concern. A debtor on the eve of bankruptcy usually faces a

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financial crisis. One of the virtues of a bankruptcy proceeding is that it creates an automatic stay that prevents creditors from prematurely depleting the resources of the debtor.\(^{110}\) A debtor employing the postponement strategy must weather the financial crisis without the benefit of an automatic stay. In the worst case, this may mean that creditors deplete the firm’s resources to the point where it is no longer a viable going concern. The more common case is that the firm will confront high transaction costs in order to remain operational while implementing the postponement strategy. For example, the firm might have to engage in additional financing at highly unfavorable terms.

While an ex post analysis reveals several flaws in § 547 of the Bankruptcy Code, an ex ante analysis strongly suggests that the section is both ineffective and costly. The snapshot approach to determining a preference permits sophisticated agents to easily evade the prescriptions of the section. More importantly, the forms of evasion open to debtors and creditors are highly costly. The combination of these two ex ante defects means that § 547 is not likely to achieve the normative goal of protecting creditors from strategic behavior on the eve of bankruptcy, but it will impose significant costs on the parties involved in secure transactions. In other words, § 547 imposes a high price for little, if any, benefit.

G. Ex Ante Assessment of the Proposals for Improving § 547

An ex ante perspective reveals additional flaws in the recommendations for improving § 547 of the Bankruptcy Code. Section 547’s ninety-day pre-petition period facilitates evasion by sophisticated actors because it is constant and easily recognizable. Both of the suggested strategies retain this element and are therefore similarly susceptible to evasion. A debtor may shield transfers to a fluid asset that are outside the ordinary course of business by ensuring that the transfers occur more than ninety days before the bankruptcy petition. Kronman’s suggestion may actually provide a debtor with an additional avenue for evasion. By timing the transfers to the fluid asset and the petition for bankruptcy so that they imitate a normal cycle of the fluid asset, a debtor may mask preferential transfers to the secured creditor under the disguise of a cyclical fluctuation. The debtor could then litigate this point against a trustee’s avoidance powers. More importantly, neither of the strategies provides any method of decreasing the costs associated with compliance or evasion of § 547. Like § 547, both recommendations (and a fortiori the synthesis of both recommendations) offer little in the way of effectively policing strategic behavior while imposing a heavy toll on the traffic of floating liens.

The Unique Problem with Fluid Assets

The discussion so far has grappled with the dynamism of assets. Although there has been an exclusive focus on fluid assets, the arguments are generally applicable to both fluid assets and static assets because both are dynamic. Yet, fluid assets pose unique and significant problems for any regime attempting to police floating liens. First, fluid assets are not only dynamic in terms of involving a stream of inputs and outputs; their content is also dynamic, meaning that the value of the fluid asset may radically change. Second, fluid assets are more opaque than static assets. The precise content of a fluid asset is the consequence of a myriad of factors related to the business. Moreover, common life experience does not provide a hardened understanding of fluid assets. These two unique attributes create a significant barrier to effective legal regulation of floating liens. The dynamic content of fluid assets makes radical shifts in value a legitimate possibility while the obscurity of fluid assets renders investigation difficult, if not impossible.

Again, neither of the suggestions for improving § 547 addresses this aspect of fluid assets. Beyond the problems associated with distinguishing between transactions in the ordinary course of business and transactions out of the ordinary course of business, the opacity of fluid assets makes fraudulent conveyance attacks a clumsy tool for addressing abusive behavior. In order to determine if an increase in the value of an encumbered asset is preferential, the bankruptcy trustee must understand the set of business forces shaping the content of the fluid asset. The context of abusive behavior exacerbates this problem. A debtor attempting to favor a secured creditor may attempt to obfuscate its behavior by fashioning fictitious reasons for increasing the value of the fluid asset. Regardless of the actual circumstances, this possibility creates uncertainty in the trustee concerning the information that it receives describing the transactions with the fluid asset. Consequently, not only must the trustee understand the business model of the debtor, it must do so with information that is unreliable at best and false at worst.

Given the unique characteristics of fluid assets, empowering the trustee to attack single transactions under the fraudulent conveyance doctrine deepens the problem associated with employing fraudulent conveyance attacks—high transaction costs. A trustee will have to base its case on a depiction of the debtor’s business model at the point of bankruptcy and possibly a refutation of the debtor’s reasoning for increasing the value of the fluid asset. Both of these issues are fact-intensive, meaning that they require substantial investigation. This ultimately increases the costs of litigation to creditors in bankruptcy proceedings. Assuming a competitive market (no economic profit),
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creditors will pass these costs to debtors in the form of higher interest rates.

Kronman addresses the problem of asymmetrical information between the debtor, the trustee, and the courts by positing a rebuttable presumption of a downward trend. This compels the debtor to present its information concerning the cyclicality of a fluid asset if it desires to avoid a preferential attack. An implicit but crucial assumption in Kronman's scheme is that the court is able to assess the validity of the information that the debtor reveals. In other words, a court can determine reasonably well if the increase in the value of the asset is due to a cyclical fluctuation. In the case of cyclical fluctuations, this assumption is plausible. The cycles of businesses are apparent from daily experience (e.g., farms have greater values in crops during harvest time and stores have greater inventories before the holiday season), and data on cyclicality is readily available from the firm's financial records or the financial records of the industry. Determining the existence and nature of commercial cycles does not require a high degree of specialty in finance or the specific business.

Kronman's strategy cannot be transplanted to the situation of fluctuations in the content of fluid assets because the court cannot reliably determine the cause of fluctuations in the content of fluid assets. In the case of cycles, the relevant data set is narrow—the firm's inventory records or the inventory records of the industry. In the case of fluctuations in the content of fluid assets, the relevant data set is practically unlimited. Since the content of a fluid asset links to many of the debtor's characteristics (e.g., growth and supply chain), the court would not even be able to determine the appropriate area to investigate. If the court relies on the presentation of the debtor, then it cannot check for possible fabrications. If the court does not rely on the debtor's statements, it must evaluate the debtor's entire business model, a daunting enterprise.

More importantly, analyzing fluctuations in the content of fluid assets requires a high level of expertise. The analysis does not require the court to merely extrapolate a pattern from a set of data. Rather, the analysis requires an assessment of a cause-and-effect theory proffered by the debtor. This means that the court would, at a minimum, have to understand the basic mechanics of finance. To be more accurate, the court would have to understand the dynamics of the specific industry. The expertise and broad investigation that Kronman's strategy requires does not make such a strategy a viable solution to grapple with the problem of detecting abusive behavior in the fluctuations of the contents of fluid assets.
I. The Matrix Test

The discussion thus far suggests three sets of goals for a replacement for § 547 of the Bankruptcy Code. First, from an ex post perspective, the provision should capture abusive behavior while permitting legitimate fluctuations in the value of fluid assets. This means that the provision must be able to discriminate between additions to fluid assets that are meant to favor a secured creditor and additions that are necessary because of the debtor’s business model. The provision should attempt to accomplish this task with a minimal amount of transaction costs. Second, from an ex ante perspective, the provision should not be susceptible to evasion by sophisticated debtors and creditors, and the provision should impose as small a cost to these actors (in terms of distorting their behavior) as possible. These goals recommend a scheme that is dynamic instead of set, so as to frustrate attempts to plan around the scheme (and therefore cause less distortion in the behavior of actors). Finally, the provision should be sensitive to the unique nature of fluid assets. The provision should attempt to accommodate legitimate changes in the content of fluid assets while simultaneously detecting and preventing abusive transfers on the eve of bankruptcy.

A strategy that addresses all these concerns employs data on the encumbered fluid asset and the debtor’s gross revenues to create a net for strategic behavior (the “Matrix Test”). The first component of this strategy, the “Cycle Mark,” is a measure of the cyclical nature of the encumbered fluid asset. The Cycle Mark is an average of the percentage change in the value of the fluid asset from period to period. In creating the Cycle Mark, all data from the inception of the debtor is employed (not just data from the time of encumbrance). This permits a larger data sample. However, if there is a change in the general pattern either at the date of encumbrance or after the date of encumbrance, then data following the change is excluded. This purges the Cycle Mark of the effects of covenants in the security interest agreement or strategic behavior in anticipation of bankruptcy. Employing percentage changes instead of absolute figures abstracts from general trends in the growth of the fluid asset. Because it is an average of the fluctuations in the fluid asset over several years, the Cycle Mark mutes aberrations in the volatility of the fluid asset. The second component of this strategy, the “Trend Mark,” is a measure of the general trends in the level of the fluid asset. First, the value of the fluid asset is adjusted according to the Cycle Mark. This distills cyclical influences from the value of the fluid asset. The Trend Mark is the map of fluctuations in the fluid asset created by calculating the percentage change in the value of the fluid asset from month to month. The “Function Mark” is a measure of the relation between the fluid asset and the debtor’s
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business. First, the shift in the debtor’s gross revenue between months is calculated. These shifts are then compared to the Trend Mark to map a relation between shifts in the value of the fluid asset and shifts in the value of gross revenues. Gross revenue is employed because it captures the activity of the debtor with a minimum of potential for manipulation. Each of the Cycle Mark, the Trend Mark and the Function Mark use data up to the point where the Matrix Test begins its analysis. This cut-off expunges the influences of strategic behavior from the indicators. (See Figure 7.)

With these three components, the Matrix Test involves a two-prong analysis to detect preferential transfers on the eve of bankruptcy. The starting point for the Matrix Test is the date of the low-point of the Trend Mark immediately preceding the petition for bankruptcy where the value of the fluid asset leaves the secured debtor under-secured. If the petition for bankruptcy occurs during a negative trend of the asset, then the low-point preceding such negative trend serves as the reference mark for the Matrix Test. The first prong of the Matrix test uses the Cycle Mark to detect abusive behavior employing cyclicality. Using the Cycle Mark as a reference, the trustee attempts to identify a change in the cyclicality of the asset that precedes the petition for bankruptcy. Changes that do not favor the creditor (e.g., the fluid asset does not experience the positive change suggested by the Cycle Mark) are accepted. This incorporates an assumption of a negative trend for the value of the fluid asset on the eve of bankruptcy into the Matrix Test. Changes that favor the creditor (e.g., the fluid asset does not experience the negative change suggested by the Cycle Mark) proceed to a second level of investigation. If the deviation from the Cycle Mark begins at the point of encumbrance (or could have begun at the point of encumbrance), then the change is accepted as a covenant in the security interest. If the deviation from the Cycle Mark begins after the point of encumbrance, then the difference between the actual value of the fluid asset and the value suggested by the Cycle Mark is subject to scrutiny under the second prong of the Matrix Test. If the asset does not exhibit cyclicality, then no adjustment according to the Cycle Mark is necessary, and the Matrix test proceeds to the second prong.

The second prong of the analysis considers trends in the fluid asset in relation to the Function Mark. If the changes in the trend value of the fluid asset are less favorable to the secured creditor than what is predicted by the Function Mark, then the transactions involving the fluid asset are accepted. If the changes in the trend value of the fluid asset are more favorable to the secured creditor than what is predicted by the Function Mark, then a preference is calculated in the following fashion: First, the

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111 Unlike profits, gross revenues are not susceptible to manipulation by creative accounting.
The Cycle Mark is extracted from the raw data on the value of the fluid asset by normalizing the fluctuations in the value of the fluid asset. Applying this normalized pattern to the raw pattern of fluctuations in the value of the fluid asset provides the Trend Mark.

previous negative trend in the Trend Mark is extended to the day of the petition for bankruptcy. Then, the difference between this imputed value and the actual value of the fluid asset is voided as a preference.

Two examples illustrate how the Matrix Test operates with respect to cyclical fluid assets and non-cyclical fluid assets. In the first example,
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assume that Debtor A has pledged its inventory and all after-acquired inventory to Creditor B as part of a secured loan three years before Debtor A’s bankruptcy. Debtor A’s inventory usually increases by twenty-five percent in November but decreases to the normal level by January. Debtor A declares bankruptcy in January. One year before filing for bankruptcy, Debtor A’s business encounters economic troubles and gross revenues begin to decrease with an accompanying decrease in inventory levels. Five months before declaring bankruptcy, the debtor’s inventory level is at its nadir, leaving Creditor B unsecured. Debtor A increases inventory levels during the five months up to the point of bankruptcy to favor Creditor B. The Matrix Test would begin its analysis five months before Debtor A’s petition for bankruptcy (inventory had a positive trend on the date of bankruptcy and the nadir of the value of the fluid asset occurred five months before petition). Applying the Cycle Mark, the Matrix Test would identify the cyclicity between November and January and determine that the fluid asset should have decreased to normal levels instead of continuing to increase. Since the change in the level of the fluid asset occurs after encumbrance and the deviation is greater than that predicted by the Cycle Mark, the Matrix Test proceeds to the second prong of the analysis. Since inventory levels were decreasing with gross revenues, the Function Mark would describe a positive relation between the two values. Employing the Function Mark, the Matrix Test would determine the appropriate inventory value for Debtor A, given Debtor A’s gross revenues near the petition for bankruptcy. The difference between this calculated inventory value and Debtor A’s actual inventory value would be set aside as a preference.

In the second example, assume that Debtor X has pledged its inventory and all after-acquired inventory to Creditor Y as part of a secured loan three years before Debtor X’s bankruptcy. Debtor X’s inventory does not exhibit any cyclicity. One year before filing for bankruptcy, Debtor X’s business encounters economic troubles, and gross revenues begin to decrease with an accompanying decrease in inventory levels. Five months before declaring bankruptcy, Debtor X’s inventory value is at its nadir, leaving Creditor Y unsecured. Debtor X increases inventory levels during the four months up to the point of bankruptcy to favor Creditor Y. However, Debtor X allows inventory levels to decrease slightly (leaving Creditor Y slightly undersecured) one month before bankruptcy. The Matrix Test analysis begins five months (the penultimate nadir of the value of the fluid asset) before the petition for bankruptcy because the value of the fluid asset is in a negative trend at the date of the bankruptcy petition. The Cycle Mark would indicate that the inventory is not cyclical, and the Matrix Test would proceed to the second prong of the analysis. Since inventory levels were decreasing with gross revenues, the Function Mark
would describe a positive relation between the two values. Employing the Function Mark, the Matrix Test would determine the appropriate inventory value for Debtor X, given Debtor X’s gross revenues near the petition for bankruptcy. The difference between this calculated inventory value and Debtor X’s actual inventory value would be set aside as a preference.

J. Ex Post Advantages of the Matrix Test

Many of the problems pertaining to § 547 arise from the snapshot approach prescribed by the section. Section 547 employs the value of the fluid asset ninety days before the petition for bankruptcy as a standard for preferential adjustments. This method necessarily excludes the possibility of growth and cyclical fluctuations. Instead of a snapshot approach, the strategy of the Matrix Test applies past data on the fluid asset’s cyclical and growth to detect possible abusive behavior. This permits the Matrix Test to address the problems of under-inclusiveness and over-inclusiveness that plague § 547. If the beginning of the pre-petition period coincides with the nadir of a cycle, then § 547 will be over-inclusive, and if the pre-petition period commences at the peak of a cycle, then § 547 will be under-inclusive. The Matrix Test avoids both of these problems by impounding cyclicality into the determination of a preference through the use of the Cycle Mark. The Cycle Mark is based on the debtor’s past behavior (or industry data, if that data is not available). This feature permits the Cycle Mark to accurately adjust the face value of the fluid asset for cyclical fluctuations in a manner that is specifically tailored to the debtor. Whereas the Two-Point Net Improvement Test does not attempt to grapple with cyclical fluctuations at all, the Matrix Test minimizes error due to cyclical fluctuations by adjusting the value of the fluid asset based on past cycles.

The Matrix Test also addresses under-inclusiveness in the ninety-day benchmark. The ninety-day benchmark generates under-inclusiveness if the value of the fluid asset is particularly high on the beginning day for non-cyclical reasons (e.g., if the value of the fluid asset had not begun to deteriorate). Because the reference is artificially high and the creditor can increase the value of the fluid asset with impunity, the secured creditor can improve its situation by the difference between the value at the beginning of the pre-petition period and the lowest value of the fluid asset during the pre-petition period. The Matrix Test avoids this flaw through two qualities that cover both of the gaps in § 547. First, the Matrix Test does not use any pre-determined point in time as a reference for the value of the fluid asset. Rather, the trend of the value of the fluid asset determines the reference value, blocking the possibility of accidentally employing a high point for the reference value. Second, the Matrix Test incorporates a check on
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upward trends. If there is an upward trend in the value of the fluid asset, then it must correlate with an upward trend in the debtor's gross revenues. This requirement bars a debtor from increasing the value of the fluid asset for purely abusive purposes. The Matrix Test evades the under-inclusiveness of § 547 by employing a more accurate reference and by checking fluctuations in the value of the fluid asset on the eve of bankruptcy.

Kronman’s strategy and the Fraudulent Conveyance Strategy both address several of § 547's ex post shortcomings, and combining the two strategies resolves all of the section’s ex post flaws; however, the Matrix Test is superior to these strategies because it does not impose the significant transaction costs that they necessitate. Under Kronman’s strategy, a creditor must litigate each instance of cyclicality. Under the Fraudulent Conveyance Strategy, a trustee must establish that a transfer is out of the ordinary course of business in order to avoid the transfer. The synthesis of the two strategies imposes both types of litigation. The Matrix Test minimizes transaction costs by adjusting to fluctuations without the need for litigation and by employing transparent information as a basis for its filter. The first benefit makes the Matrix Test less costly in comparison to all of the other strategies. The Cycle Mark and the Trend Mark capture cyclical fluctuations and abusive transfers on the eve of bankruptcy without resort to litigation. The Matrix Test automates these considerations by incorporating these indicia into the calculations of the appropriate value of the fluid asset.

The transparency of the data that the Matrix Test employs also makes it less costly than the Fraudulent Conveyance Strategy (and, a fortiori, the synthesized strategy). Determining whether a transaction is part of the ordinary course of business can be a difficult and fact-intensive investigation that increases the costs of litigation. In contrast, the Matrix Test employs data that is readily available and non-controversial. The value of the fluid asset during various months and the gross revenue generated during those months are clear indicators that are not subject to much interpretation. By employing these data to grapple with abusive behavior, the Matrix Test provides an inexpensive alternative to the Fraudulent Conveyance Strategy.

As a final consideration, the Matrix Test is superior to the other alternatives to the current § 547 because it is non-elective and therefore less subject to oversight by counsel. Both Kronman’s strategy and the Fraudulent Conveyance Strategy require action on the part of the creditor or trustee in order to correctly capture the value of the fluid asset. The creditor must raise an argument for cyclicality while the trustee must investigate the transactions within the ninety-day period. By incorporating these factors into the calculus for the legitimate value of the fluid asset, the
Matrix Test produces two benefits. First, the trustee and the creditor need no longer dedicate their efforts to monitoring these aspects of the floating lien, saving time and cost. Second, the process is not subject to human oversight. Under the alternative strategies, including cyclical fluctuations and excluding fraudulent transfers depends on the competence and diligence of the trustee and creditor. The Matrix Test eliminates this possible source of error by automating the process. Automation generally raises concerns about less discretion; however, in this case discretion does not seem warranted. If there are instances in which cyclicity should be excluded and fraudulent transfers should be included, then leaving these considerations to human judgment may merit consideration. However, both factors have a categorical desirability or undesirability, making automation preferable. In addition to lower litigation costs, the Matrix Test provides a more efficient and thorough process for treating cyclical fluctuations and abusive transfers.

K. Ex Ante Benefits of the Matrix Test

The Matrix Test also has several ex ante benefits. Sophisticated agents will learn the relevant law and adjust their behavior correspondingly. As a consequence, for a test to be binding from an ex ante perspective, it must afford little opportunity for evasion, even given a command of the elements of the test. There are two possible methods of achieving this objective. First, the test can rely on information that the agents cannot determine from an ex ante perspective. Second, the test can react to strategic behavior.

The Matrix Test primarily employs the downward trend precipitating bankruptcy to determine the legitimate value of the fluid asset. This factor applies the strategy of ex ante uncertainty to frustrate strategic behavior. A debtor may avoid a preference attack by fortifying the value of the fluid asset in anticipation of the reference point. Yet, this requires that the debtor be able to identify the reference point ex ante. The virtue of employing a downward trend is that the trend is only noticeable after it has occurred. A debtor will only know how inventory changes after it changes. This means that the debtor cannot prepare for the reference point in the Matrix Test because it cannot determine ex ante what the reference point will be.

The second virtue of employing the downward trend is that it passively adjusts to the strategy of postponement, effectively allowing the Matrix Test to respond dynamically to postponement strategies. Confronting a test with a definite time frame, a debtor may postpone bankruptcy in order to shift transfers out of the scope of the test. The downward trend is not fixed at a certain amount of time. Rather, it is based
on a condition of the company. Thus, as long as the condition obtains, the
debtor cannot escape the force of the Matrix Test by merely postponing the
petition for bankruptcy.

A debtor with an encumbered cyclical fluid asset may nonetheless
employ a postponement strategy in order to exploit the expected cyclical
fluctuations of a fluid asset as a front for improving the secured creditor’s
position. Here, the Matrix Test responds to the debtor’s behavior by
implementing either a ban on the increased level, if the petition occurs at
or before the peak of the cycle, or by creating a requirement that the cycle
match a shift in the debtor’s gross revenue.

Finally, a debtor may fortify the value of a fluid asset after the
commencement of a downward trend, creating either a spike in the value
or an upward trend. The Matrix Test responds to this contingency by
checking the upward shift against the gross revenues of the debtor in the
same period. This additional test separates increases due to legitimate
business purposes from increases due to abusive purposes by assuming a
positive correlation between the value of the fluid asset and the value of
gross revenues. More importantly, gross revenues are not susceptible to
manipulation by the debtor or secured creditor. This creates an absolute
check on the strategic behavior of the parties.

The combination of the Matrix Test’s variability and dynamism
provides it with greater actual effect than § 547’s Two-Point Net
Improvement Test. If debtors and creditors cannot evade the Matrix Test,
they will nonetheless incur costs in abiding by the test. Fortunately, these
costs mark a price for socially desirable behavior instead of a deadweight
loss. Moreover, the data-dependent nature of the Matrix Test means that it
imposes few costs on debtors and creditors.

The basis of the Matrix Test is the debtor’s business data. With this
data, the Matrix Test fashions a multi-layered filter that strips away the
cyclical and non-cyclical fluctuations attendant to fluid assets in order to
provide a grasp on the legitimate value of the fluid asset. The empirical
foundation of the test and its normalizing process produce two types of
savings to secured financing in terms of compliance. First, the Matrix Test
only requires that the debtor and creditor maintain adequate records to
provide a foundation for the test. This requirement is already imposed by
several other conventions (most importantly, accounting requirements and
tax audits). At most, the Matrix Test imposes a marginal addition to the
record-keeping costs of debtors and creditors. Second, and more
importantly, the process of the Matrix Test accommodates much of the
activity of the fluid asset. Unlike Kronman’s strategy, the Matrix Test does
not require debtors to actively defend cyclical fluctuations. The
transparency of the Matrix Test permits debtors and creditors to have an
undistorted set of financial options. The context for the Matrix Test, the
eve of bankruptcy, makes this financial freedom especially valuable as it affords debtors the full range of instruments to cope with insolvency.

L. Advantages of the Matrix Test in Policing Fluid Assets

There are two possible general strategies for policing the dynamic contents of fluid assets. First, the test may employ the judgement of courts and trustees in detecting and prosecuting abusive behavior disguised as shifts in the content of fluid assets. Alternatively, the test may apply statistical data to determine the presence of abusive behavior. Both the complexity of the content of fluid assets and the alien nature of fluid assets recommend the latter strategy.

Kronman's strategy and the Fraudulent Conveyance Strategy are less capable of grappling with the dynamism of the content of fluid assets than the Matrix Test because they are both active, relying on the trustee or the creditor to delineate appropriate adjustments. While this strategy may be appropriate for other forms of fluctuations, it involves too wide a margin of error in the case of fluid assets. To accurately prosecute an abuse concerning the content of a fluid asset, a trustee or court must effectively understand the business model of the debtor. The business judgment rule establishes an assumption that courts should not second-guess the decisions of disinterested management.\textsuperscript{112} Unfortunately, in the present case, management's motives are suspect at best. Thus, an active test runs into a dilemma. On the one hand, the courts do not have a comparative advantage over management in financial decisions. On the other hand, management cannot be trusted in this context to behave according to the spirit of § 547. Indeed, to assume so would obviate the need for any investigation at all. Given the dubious quality of either of the tactics available under an active strategy, a passive strategy merits consideration.

Rather than attempt to unravel the intricate network of factors affecting the content of fluid assets, the Matrix Test identifies abusive behavior by attending to its symptoms. Fluid assets, like all assets, have two costs, the cost of acquisition and the cost of maintenance. Ceteris paribus, businesses prefer to hold less fluid assets because they incur less maintenance costs. Thus, adjustments to the contents of fluid assets generally involve decreasing the size of the fluid asset in order to increase operational efficiency. The eve of bankruptcy emphasizes this rule because firms are generally cash- and resource-constrained before the petition for bankruptcy. The Matrix Test reflects these financial factors by assuming a downward trend in the value of the fluid asset on the eve of bankruptcy. The most significant exception to these trends is firm growth. If the firm's

business expands, it requires more resources to meet demand. The Matrix Test tracks this exemption by permitting an upward shift in the value of the fluid asset on the eve of bankruptcy if it is accompanied by growth in the gross revenue. The implicit assumption that arises from this system, and the engine that detects abusive behavior in the Matrix Test, is that an upward trend in the value of the fluid asset without an upward shift in gross revenues marks manipulation of the content of a fluid asset for purely strategic reasons.

The specter of managerial mistake does not challenge the validity of this mechanism. If the debtor increases the value of the fluid asset because of an inefficient decision, the result is a mistaken but unintentional boon to the secured creditor. The inadvertent nature of this manipulation may exonerate the debtor of intentional abuse, but it does not legitimize the transfer to the value of the fluid asset. Under the Revised Transfer Intuition, transfers to the fluid asset are only valid if they are recuperative. If the debtor mistakenly expanded the value of the fluid asset, the transfers are not recuperative because they do not represent replenishment of the content of the fluid asset, but rather an augmentation of the content of the fluid asset.

M. Limitations of the Matrix Test

The Matrix Test improves upon the current § 547(c)(5) test by creating a finer net for abusive behavior on the eve of bankruptcy. While this affords the Matrix Test significant transaction cost advantages over Kronman’s strategy or the Fraudulent Conveyance Strategy, it also creates unavoidable inaccuracies.

First, the Matrix Test employs past data to create the standards for strategic behavior, the Cycle Mark and the Trend Mark. Ideally, these marks would perfectly capture the cyclicality and growth of the fluid asset; however, the Cycle Mark and Trend Mark are actually means or projections from data, making them generally correct, but far from precise. Consequently, this may require a certain amount of latitude in the application of the Matrix Test. For example, a strict application of the Cycle Mark would void a deviation of one percent. Yet, such a deviation could be as much a sign of the imperfections of standard rather than abusive behavior. Indeed, the small amount would favor the former interpretation. While this is a theoretical deficiency of the Matrix Test, it will probably not be practically significant. If a deviation from the Cycle Mark or Trend Mark is sufficiently small to warrant concerns of imperfections, then it would probably not merit the attention of the parties at hand.
Second, there may not be enough data to implement the Matrix Test. In order to be customized to the firm, the Matrix Test requires more than one year of data on the fluid asset (one year to establish the Cycle Mark, and the additional time for application that does not completely overlap with the Cycle Mark). A credible Cycle Mark requires multiple years of data in order to control for aberrations. Most firms that employ secured financing, especially liens on fluid assets, tend to be small or medium-sized firms. This suggests a relatively short life span for the firm, meaning that a robust Cycle Mark may not be possible.

Despite its practical importance, this problem may be overcome by supplementing data on cyclicality with industry data. While it may be common that a specific firm only exists for a year or less, the industry may have several firms that have existed for several years (either individually or as a collection). This provides a sufficient data pool for a template for cyclicality (although not customized to the debtor).

An important note is that these limitations are not unique to the Matrix Test. Both Kronman’s strategy and the Fraudulent Conveyance Strategy employ an open reliance on litigation to address the tasks accomplished by the Cycle Mark and Trend Mark. This litigation will undoubtedly entail data on the debtor’s past cyclicality and growth (whether to establish a cycle or to establish that a transfer was outside the ordinary course of business). The Matrix Test crystallizes and automates this process, thereby minimizing the costs associated with these considerations. The Matrix Test is an imperfect net, but it is the best net, all costs and benefits considered, to cast upon floating liens.

IV. True Sale in Asset Securitization

The discussion up to this point has focused exclusively on a second-best solution to the difficulties surrounding fluid assets and floating liens in the sense that § 547(e) of the Bankruptcy Code and the Matrix Test merely respond to the conceptual opacity of fluid assets. An ideal strategy would be to eliminate, rather than merely accommodate, the dynamism of fluid assets. In this Part, I argue that asset securitization represents such a first-best solution by divorcing fluid assets from the origin of their dynamism. Courts, however, have failed to recognize this inadvertent virtue in structured financing and have subjected structured financing to an unnecessarily restrictive set of tests to ensure that the transaction is not merely a floating lien in different form. I propose several methods of revising the “True Sale” test for asset securitization that would not only generate a jurisprudential recognition of the virtues of structured financing but also eliminate a startling discrepancy between the definition of a “sale” in the context of securitized assets and all other contexts.
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A. An Overview of Asset Securitization

Asset securitization, also known as structured finance, is “becoming one of the dominant means of capital formation in the United States.”\textsuperscript{113} The essence of asset securitization is the conversion of financial assets into capital market instruments.\textsuperscript{114} First, the firm receiving the financing, the “originator,” identifies financial assets that will be involved in the structured financing.\textsuperscript{115} These financial assets often involve sets of rights to payment, often referred to as “receivables.”\textsuperscript{116} The originator creates a trust, corporation or other legally distinct entity, known as a “special purpose vehicle” (“SPV”), to which it transfers the receivables.\textsuperscript{117} The SPV issues securities in the capital markets and pays for the originator’s receivables with the proceeds.\textsuperscript{118}

The popularity of asset securitization stems from the decreased costs of capital it provides to both investment-grade and non-investment-grade debtors.\textsuperscript{119} When a firm borrows money on a secured or unsecured basis, the cost of capital includes the riskiness of the firm because the debtor must account for the contingency of debtor bankruptcy. The SPV is a legally distinct entity and therefore is not affected by the bankruptcy of the originator. As a consequence, the securities issued by the SPV will be valued only on the basis of the receivables. The originator, in effect, separates the influence of its identity from the pricing of the receivables. In the case of non-investment-grade companies, this separation creates a large savings in the cost of capital because the originator’s riskiness does not permeate into the SPV’s share pricing. A non-investment-grade company may attain the investment-grade costs of capital through structured financing if the quality of the receivables is high.

Even relatively stable companies may benefit from asset securitization. If the risks associated with the receivables alone are less

\textsuperscript{113} Investment Company Act Release No. 19105, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) \$ 85,062, at 83,500 (Nov. 19, 1992) (provided in connection with the issuance of Rule 3a-7 under the Investment Company Act of 1940); see also Schwarcz, \textit{Parts, supra} note 9, at 140.

\textsuperscript{114} Schwarcz, \textit{Parts, supra} note 9, at 140.

\textsuperscript{115} \textit{Id.} at 143.

\textsuperscript{116} \textit{Id.} The Article refers to “future payment streams,” rather than “receivables.”

\textsuperscript{117} \textit{Id.} at 144.

\textsuperscript{118} \textit{Id.}

\textsuperscript{119} There is a warm debate concerning whether the benefits from asset securitization represent a zero-sum game (where debtors are gaining cheaper capital at the cost of general creditors) or a genuine creation of wealth. See, e.g., Lynn M. LoPucki, \textit{The Death of Liability}, 106 YALE L.J. 1 (1996); Lynn M. LoPucki, \textit{Virtual Judgment Proofing: A Rejoinder}, 107 YALE L.J. 1413 (1998); Lois R. Lupica, \textit{Asset Securitization: The Unsecured Creditor’s Perspective}, 76 TEX. L. REV. 595 (1998); James J. White, \textit{Corporate Judgement Proofing: A Response to Lynn LoPucki’s The Death of Liability}, 107 YALE L.J. 1363 (1998). This debate is beyond the scope of this Article. This Article focuses on legitimate means of reducing the transaction costs associated with asset securitization—a benefit that applies in either case.
than the risk of the receivables in the originator’s business, then asset
securitization affords lower interest rates for investment-grade companies.
Moreover, asset securitization provides the benefits of an off-balance-sheet
structure. When a firm borrows money, it increases its debt-to-equity ratio.
This increases the risk of the firm because greater debt decreases the firm’s
ability to absorb and survive economic downturns. By raising capital
through structured financing, the originator does not incur more debt.
Rather, it sells an asset. This means that the firm’s debt-to-equity ratio is
not affected. Decreasing risk (more accurately, avoiding an increase in
risk) provides savings to the firm in terms of raising capital in other areas.

Asset securitization does not provide a pure benefit to originators.
Structuring the transaction entails significant transaction costs. In “one-
off” transactions, an SPV is created specifically for a single originator and
a particular transaction.120 The originator bears the legal fees and banking
fees associated with the transaction. A “multiseller securitization conduit”
creates an SPV for multiple originators that have similar receivables.121
This creates a transaction cost economy of scale by permitting multiple
originators to share the legal fees and banking fees associated with the
creation of the SPV. In either one-off transactions or multi-seller
securitization conduits, the benefits that originators extract from structured
financing is the difference between the savings in costs of capital over the
next best alternative and the additional transaction costs over the next best
alternative. Consequently, firms will not employ asset securitization if the
transaction costs overwhelm the savings in costs of capital. Decreasing the
transaction costs associated with structured finance increases social
welfare by making asset securitization a viable financing option for more
firms and increasing the benefits of asset securitization for firms already
employing the scheme.

B. The True Sale Requirement

Perhaps the greatest threat to a structured financing is that a
bankruptcy court will characterize the transaction as a secured loan instead
of a true sale. Section 541 of the Bankruptcy Code defines the bankruptcy
estate to include all “legal or equitable interests of the debtor in property as
of the commencement of the case.”122 If the originator did not sell the
receivables to the SPV, but instead employed the receivables as collateral
for a loan, then the originator would still have legal interests in the
receivables, thereby making the receivables part of the bankruptcy estate.
Under § 362 of the Bankruptcy Code, the receivables would then be

120 Schurcz, Alchemy, supra note 2, at 138.
121 Id. at 140.
subject to an automatic stay against any collection attempts by the SPV, and the trustee could actually persuade the court to allow it to continue to use the receivables as working capital. Such an interpretation completely unravels the structured financing as the SPV would, at the very least, experience a delay in acquiring the receivables, and at worst, may not be able to acquire the receivables at all. The ex ante effect is more daunting. Asset securitization provides benefits to originators by divorcing the receivables from the originator. The threat of recharacterization discredits the force of this separation. Investors will not be willing to value the SPV as a separate entity if a bankruptcy court can simply pull the receivables into the bankruptcy estate. The requirement of a “true sale” between the originator and the SPV strikes at the very heart of asset securitization.

Federal courts often rely on state law to bolster the Bankruptcy Code. The drafters of the UCC recognized that it is often difficult to distinguish between sales of accounts and secured loans. Thus, Article 9 of the UCC, which generally covers secured loans, also pulls sales of accounts into its ambit. More importantly, Article 9 incorporates a substance over form approach in determining the nature of any transaction. This means that an originator cannot make a transaction a sale by merely referring to it as a sale or even performing the actions often associated with a sale (e.g., a simultaneous exchange of funds and property). Rather, the UCC instructs courts to look to the substance of the transaction, whether its traits are more similar to a secured loan or an actual sale, in classifying the transaction.

The determination of whether any specific transfer constitutes a “true sale” is a case-specific analysis. Although there is no uniform standard for analysis, the case law has created a patchwork set of criteria for determining whether a transfer is a true sale or a secured loan. The four factors determining a true sale are: (1) right to recourse, (2) retained rights (specifically rights to surplus), (3) the pricing mechanism, and (4) administration of the accounts.

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123 Id. § 362.
124 Id. § 363.
127 Id. § 9-202.
128 Schwarcz, Parts, supra note 9, at 145.
129 Id. at 145-49.
1. Recourse

The nature of the rights of recourse that a transferee has against a transferor is arguably the most significant factor in determining whether a transaction is a true sale or a secured loan. The existence of some recourse rights will not automatically disqualify a transaction as a sale. However, the greater the extent of the transferee’s recourse rights, the closer the transaction appears to a secured loan instead of a sale. A basic rationale for this standard is the allocation of risks in normal purchases and secured loans. The purchaser of property presumably assumes all risks associated with fluctuations in the value of the property. For example, when an individual purchases a share of stock, she assumes the risk that the stock will depreciate. A secured creditor’s right to repayment does not shift with the value of the collateral. Even if the value of the collateral deteriorates so that the secured creditor is under-secured, it still has rights to repayment as a general creditor.

In the leading case on recourse, Major’s Furniture Mart v. Castle Credit Corp., the court clothed this rationale in terms of the guarantees that the seller provides to the buyer. If there is recourse in the sales agreement, then the inquiry shifts to “whether the nature of the recourse, and the true nature of the transaction, are such that the legal rights and economic consequences of the agreement bear a greater similarity to a financing transaction or to a sale.” In making this determination, the court must consider the parties’ “practices, objectives, business activities and relationships.” Major’s Furniture Mart warranted the receivables in three manners. First, it guaranteed that the customers met certain criteria established by Castle Credit. Second, it promised to perform credit checks to verify the criteria that Castle Credit demanded, and third, it certified that the accounts were legally enforceable. In addition to these warranties, Major’s Furniture Mart also agreed to indemnify Castle Credit for any customer’s failure to pay and to repurchase any accounts that were outstanding for over sixty days. The court ruled that the transaction was a secured loan. While the warranties alone would not have disqualified the transaction as a sale, the promises to indemnify Castle Credit and repurchase delinquent accounts pushed the transaction beyond the scope of

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130 Major’s Furniture Mart v. Castle Credit Corp., 602 F.2d 538, 545 n.12 (3d Cir. 1979);
GRANT GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY § 44.4 (1965); Schwarcz, Parts, supra note 9, at 145.
131 Major’s Furniture, 602 F.2d at 544 (internal citations omitted).
132 Id. at 545.
133 Id.
134 Id.
135 Id. at 546.
normal sales because Castle Credit did not incur any of the risks attendant to ownership.\textsuperscript{136}

Major's Furniture Mart establishes two general guidelines for recourse. First, the case suggests that the transferor may provide warranties concerning the quality of the receivables (and support the warranties with appropriate behavior); however, the transferor cannot go so far as to agree to repurchase bad accounts or indemnify the transferee for bad accounts. Thus, the line seems to be between screening the receivables for quality before the transaction and simulating quality after the transaction. Although the court does not mention it, a possible rationale for this distinction is that it approximates the difference between quality assurance and a guaranteed economic return. If the transferor goes so far as to indemnify the transferee for bad accounts, then it seems to be guaranteeing the transferee a certain return on its investment. This is equivalent to the guaranteed interest payments and principal repayment of a loan agreement. The second and related aspect is the amount of risk that the transferee bears. If a transferee does not bear any of the risks attendant with the fluctuations of the value of the receivables, then the transaction is a secured loan and not a sale. Again, an implicit rationale for this standard is an analogy to debt instruments. Whereas the returns of equity are variable, the returns of bonds are invariable. By placing all of the risk on the transferor, the transaction simulates the risk profile of a debt instrument.

2. Retained Rights

The extent to which a transferor retains any rights in the property conveyed to the transferee affects the characterization of the transaction. A purchaser is usually conceived of as acquiring all of the rights to the procured property. Conversely, a secured creditor only has a very narrow scope of rights to the collateral (narrow in terms of the circumstances under which it may exercise its right to the property). Consequently, the more rights a transferor retains in a property, the more the transaction appears like a secured loan rather than a true sale.

Of special interest is the right to surplus proceeds of receivables. Normally, investors value the shares of an SPV by discounting the face value of the receivables partly due to expectations that a portion of the receivables will not be paid. This raises the possibility that the SPV may collect more proceeds than expected. In this case, courts have ruled that a sales agreement granting the originator rights to excess proceeds will count

\textsuperscript{136} Id. at 545.
against the characterization of the transaction as a true sale. Beyond the point that this is retention of a right by the transferor, the right to excess proceeds seems to mirror a mandatory aspect of secured loans. Section 9-502 is a mandatory provision that grants secured creditors the right to seize and dispose of collateral to satisfy a debt in the case of a default; however, the secured creditor must return any surplus from the sale to the debtor. Rights to excess proceeds effectively grant the transferee only a certain maximum return on the investment, which brings the risk profile of the transaction dangerously close to that of debt. The transferee bears the downside risk, but it does not enjoy the upside possibilities.

An additional, but less weighty, consideration is the retention by the transferor of a redemption right. If the transferor has a right to buy back the transferred property before the SPV disposes of it, the transaction is more likely to be considered a secured loan instead of a true sale. Again, beyond the simple retention of a right, this trait of a sales agreement imitates a secured loan. Section 9-506 of the UCC permits a debtor to redeem property that a creditor has seized but not disposed of. By allowing the originator an opportunity to redeem property that the SPV has not sold, the sales agreement simulates the situation in which a creditor has levied against a piece of collateral.

3. Pricing

A method of simulating retained rights and recourse is to build adjusting mechanisms into the pricing of the transferred assets. For example, the price of the transferred assets might be retroactively adjusted in light of the proceeds from the receivables (price increases for surpluses and decreases for deficiencies). This effectively provides the transferor with the right to surplus of proceeds (the surplus would be infused into the price) and the transferee with recourse for bad accounts (the delinquent accounts would be “repurchased” through a lower price for the receivables). Accordingly, courts have stated that such retroactive pricing adjustments are indicative of a secured loan instead of a true sale. Pricing of the receivables according to some financial index, such as the

139 Schwarcz, Parts, supra note 9, at 147.
141 See, e.g., Home Bond Co. v. McChesney, 239 U.S. 568, 575 (1916); Dorothy v. Commonwealth Commercial Co., 116 N.E. 143, 149 (Ill. 1917).
142 Home Bond, 239 U.S. at 573; Dorothy, 116 N.E. at 149.
prime or base rate, also suggests that the transaction is a secured loan instead of a sale.143

The form of pricing that most closely approximates a true sale would be a fixed price that is not subsequently adjusted. Not only does this form of pricing superficially resemble pricing in sales, it also bars the transferor from capturing or covering specific surpluses or losses.

4. Administration of the Accounts

Courts will sometimes consider the administration of the accounts in determining whether a transfer is a secured loan or a true sale.144 The more control the SPV has over the collection process, the more likely the transfer will be considered a true sale. The rationale behind this standard is that a true sale would transfer complete dominion to the purchaser. If the SPV purchased the receivables, their disposition should be under its complete control.

Ideally, the SPV would collect the receivables itself or locate an unaffiliated collection agent.145 Normally, however, the SPV will appoint the originator as the collection agent.146 This arrangement will not invalidate the sale nature of the transaction if it meets certain standards. First, the originator must act as an agent for the SPV pursuant to established standards.147 Second, the originator's fee will approximate the fee of an arms-length negotiation between an unaffiliated collection agent and the SPV, and third, the SPV has the ability to replace the originator as a collection agent at any time.148 While the originator may act as the collection agent, these requirements effectively compel it to duplicate the arrangement between a neutral collection agent and the SPV.

An undertone to these requirements may also be the insistence that the SPV actually purchase receivables instead of merely a stream of cash flow. A corporate bond or other form of debt instrument is basically a right to a cash stream from the debtor to the creditor. In contrast, receivables represent promises by third parties to make future payments. The more

143 Schwartz, Parts, supra note 9, at 147.
145 Schwartz, Parts, supra note 9, at 148. Ideally, the SPV should have complete authority and control over the collection process:

Examples of such authority would include (1) the SPV's ownership of all books, records, and computer tapes relating to the payment stream, and (2) the SPV's having the right (a) to control the activities of the collection agent for the payment stream and at any time to appoint another collection agent, (b) to establish a credit and collection policy for the payment stream, and (c) at any time to notify the persons obligated to make the payments that the payment stream has been sold.

146 Id.
147 Id.
148 Id.
authority the originator retains over the administration of the accounts, the more the cash stream seems to be directly from the originator to the SPV (therefore simulating a debt contract). These requirements cabin the originator's power to that of the SPV's agent, thereby maintaining the sale element by ensuring that the cash stream is between third parties and the SPV.

C. Refining the True Sale Requirement

The federal bankruptcy system requires a distinction between sales and secured loans in order to determine the bankruptcy estate. Insofar as it obfuscates this distinction, asset securitization raises two concerns. First, structured financing raises the ex post problem of correctly distinguishing between sales and secured loans to correctly determine the scope of the bankruptcy estate. A concept of a sale that is overly broad depletes the bankruptcy estate by effectively granting rights to parties that did not bargain and pay for them. A concept of a sale that is too narrow denies parties their purchased rights. The more serious problem stems from the ex ante perspective. Realizing that asset securitization obscures the distinction between a sale and a secured loan, sophisticated parties may employ structured finance to straddle the distinction. A debtor could employ asset securitization as a method of favoring a secured creditor because the SPV is bankruptcy remote.

The True Sale requirement answers these concerns by delineating the distinction between a sale of fluid assets and a secured loan based on fluid assets. In establishing the contours of the areas, the courts have employed a very basic notion of a sale in terms of the relationship between the buyer and seller. Underlying much of the True Sale jurisprudence is the idea that the purchaser acquires full dominion over the asset and bears all the risks of the asset. Exported to structured finance, this bare concept of a true sale creates significant limitations on the parties' ability to allocate risks among themselves. The realities of commerce are more nuanced than the judicial opinions on the True Sale requirement suggest. Courts have recognized incidents to sales such as warranties, cost-pricing schemes, and service contracts that afford parties much latitude in apportioning risks in sales.

1. Refining the Treatment of Recourse

The judicial limitation on recourse in structured financing creates an adverse selection problem. From repeat experience with customers and an

150 The distinction between a sale and a secured loan may be attacked itself. However, this Article will not engage this subject and will assume a viable conceptual basis for the distinction.
Getting the Question Right on Floating Liens and Securitized Assets

intimate knowledge of its business, the originator has an informational advantage in terms of valuing the receivables transferred to the SPV. The originator could provide the SPV with a right of recourse for the receivables. Like recourse in other instances, recourse in receivables would serve as a signal from the originator to investors that the receivables are of a certain level of quality. This would induce investors to purchase shares from the SPV or value the shares of the SPV at a higher price. By denying the originator this signaling mechanism, the True Sale jurisprudence blocks the signal to investors. Without knowledge of the quality of the receivables, the investors must assume a worst-case scenario and price the receivables accordingly. The originator realizes this ex ante, and, in response, provides low-quality receivables so that it receives a fair price for the accounts.

The forms of warranties that the True Sale jurisprudence does permit (certification of the quality of the receivables) serve to ameliorate this problem, but they offer only limited benefits and add an additional layer of costs to the transaction. First, certification is not as strong a signal as full recourse. Certification provides data on the accounts, but it does not make the originator liable for delinquent accounts. Moreover, the certification process is subject to manipulation. For example, the originator may leverage its informational advantage by selling receivables that appear to be of high quality based on past data but are actually suspect. Second, certification introduces additional monitoring costs into the transaction. Certification is a process where the originator must share its information with the SPV, and the SPV must verify the information. Both of these processes are costly. With full recourse, certification is not necessary (or at least, a high degree of monitoring is not necessary). The originator internalizes all the risks of bad debtors by offering full recourse. Thus, it will act according to all the information it possesses. This obviates the need to share information with the SPV or, at least, to share as much information with the SPV.

The True Sale requirement’s bar on full recourse is perplexing in light of the common use of full recourse in sales of static assets. For example, computer manufacturers offer warranties for their models that bind manufacturers to fix or replace any defective machine. There is no economic difference between this form of warranty and a right of full

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152 Id.
recourse that an originator provides to the SPV. In both cases, if the product sold does not perform according to the seller's claim, the seller will either remedy the situation or replace the product. In the case of receivables, indemnifying the SPV for the amount of the accounts is equivalent to replacing the computer. If the provision of a full warranty does not compromise the status of the sale of computers, then it is inconsistent that it would compromise the status of the sale of receivables. This is especially true if courts argue that the parties' "practices, objectives, business activities and relationships" should inform the deliberation on the nature of a transaction.\(^{154}\) To count the SPV's right to full recourse as an indication that the transaction is not a true sale seems to be completely contrary to the common practice of full warranties. Indeed, the drafters of the UCC seemed to realize this when they stated, "there may be a true sale of accounts or chattel paper although recourse exists."\(^{155}\)

The ubiquity of full warranties undermines the judicial assertion that a mark of a true sale is that the purchaser bears all of the risks attendant to the transferred assets.\(^{156}\) Full warranties permit a purchaser to shift all of the risks of ownership to the seller. The seller offers a full warranty because he receives an implicit or explicit price for bearing the risk of ownership. Similarly, full recourse rights permit the SPV to shift all of the risks attendant with the receivables to the originator. The SPV also pays a price for this risk. Full recourse allows the originator to extract a higher price for the receivables because it can make a credible promise concerning their quality.

The proliferation of full warranties also undermines the implicit argument that full recourse makes the transaction too close to a secured loan because it effectively guarantees the SPV a stream of payments. From an economic perspective, the guarantee provided in full warranties is no different from the guarantee created by a right to full recourse. A physical product provides the purchaser with a stream of economic value (just like a stream of payments). The full warranty creates a legally enforceable duty on the seller to repair or replace the item or to maintain the stream of economic value. Disallowing rights to full recourse because they ensure a stream of cash flows proves too much. Because every full warranty provides the economic equivalent of a stream of cash flows, accepting this argument would transform all sales involving full warranties into secured loans.

This analysis seems to exhaust the courts' arsenal of methods to distinguish sales and secured loans in terms of recourse. Yet, this does not mean that every guarantee of cash flows is acceptable in a structured

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154 Major's Furniture Mart v. Castle Credit Corp., 602 F.2d 538, 545 (3d Cir. 1979).
156 Major's Furniture, 602 F.2d at 545.
finance. What distinguishes sales with warranties from secured loans is not the certainty of the flows of value, but the source of the certainty. In the case of full warranties, the certainty of the flows derives from the seller's guarantee to indemnify the buyer for defective goods. Thus, the certainty is entirely dependent on the nature of the goods. In the case of secured loans, the certainty of the flows arises from the debtor's independent promise to pay a certain stream of value. The collateral secures this promise, but the promise (and the stream of value) is entirely independent of the nature of the collateral.  

Sales with full warranties and secured loans may have the same economic effect, but they are conceptually distinct in terms of the origin of the certainty.

Applying this analysis to rights to full recourse in the sale of receivables illustrates that they are more like full warranties than a secured loan. The certainty of the SPV's stream of value derives from the originator's guarantee concerning the quality of the receivables. It is wholly dependent on the quality of the receivables. The SPV can only exercise its right of recourse if the account is delinquent. Scholars have termed this type of recourse as "recourse for collectibility." In contrast, the type of recourse that a secured loan provides is completely independent of the accounts. Regardless of whether the accounts are delinquent, the secured creditor has a right to a certain stream of cash. This type of recourse has been termed "economic recourse." By analogy to a sale of static assets, providing recourse for collectibility should not challenge the nature of the transaction as a true sale while providing economic recourse should count in favor of treating the transaction as a secured loan.

Adopting this distinction in the True Sale determination permits the courts to retain the crucial distinction between a sale and a secured loan for bankruptcy purposes while avoiding the costs associated with the more blunt treatment of recourse rights. Recourse of collectibility permits the originator to provide a credible signal concerning the quality of the receivables because it forces the originator to internalize the effects of poor quality. This, in turn, facilitates the asset securitization process by reducing or eliminating the monitoring costs that are necessary with mere certifications of quality.

2. Assessing the Treatment of Retained Rights

Common sale practices support the judicial treatment of retained rights. While the purchaser may displace risk to the seller, there is no convention for the seller to retain rights in property transferred in a true

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157 Pantaleo et al., supra note 144, at 171.
158 Id. at 163.
159 Id.
sale. Indeed, scholars define a true sale as "[t]he transfer of all of a person's right, title, and interest in an asset to another person."\textsuperscript{160}

More importantly, retained rights is an area where the Bankruptcy Code speaks directly to the matter, obviating the need for judicial interpretation. Section 541(a)(1) of the Bankruptcy Code states that the bankruptcy estate consists of "all legal or equitable interests of the debtor in property as of the commencement of the case."\textsuperscript{161} The courts employ the true sale determination in order to decide whether the interests represented by ownership of the receivables belong to the originator or the SPV. If the sales contract explicitly states that the originator retains some rights in the receivables, then § 541(a)(1) sweeps these rights into the bankruptcy estate (although the True Sale determination is still useful for deciding whether the receivables themselves belong in the bankruptcy estate).

3. Refining Pricing

The pricing of receivables is a mechanism to capture recourse rights and retained rights. Therefore, the judicial policy on pricing should be adjusted in light of the analysis of recourse rights. Since full recourse rights between the originator and the SPV are acceptable, the courts should allow retroactive pricing that accounts for deficiencies in the proceeds from the receivables. On the other hand, since retained rights, such as rights to surpluses and redemption rights, are not supported by common sales prices, retroactive adjustments for surpluses in proceeds should not be allowed.

The conceptual difference between full warranty sales and secured loans provides a basis for refining the judicial treatment of index pricing. If index pricing is not based on any aspect of the receivables, but completely independent data (such as the base rate), then it should weigh against determining that a transaction is a sale. As in the case of the certainty from secured loans, this type of index pricing makes the price of the receivables completely independent of the content of the receivables. In contrast, if index pricing is based on some dimension of the receivables or the processing of the receivables, then it should not count against the characterization of the transaction as a true sale. An example of such pricing would be to index the price of the receivables to the inflation rate. Inflation, as it decreases the value of nominal dollars, represents a cost of holding the receivables. The inflation rate directly impacts the value of the receivables and should be permitted as a factor in pricing. Another example of such pricing would be indexing the price to the costs of

\textsuperscript{160} Schwarcz, \textit{Parts}, supra note 9, at 150.

managing a multiseller securitization conduit. Fluctuations in this cost affect the value of the receivables.

Index pricing according to factors that are dependent on the nature of the receivables finds support in contracts that price goods according to certain relevant indexes so as to provide the seller with a somewhat regular return on cost. Index pricing according to the inflation rate or the costs of managing the SPV would have the same effect because both indicators are costs of holding the receivables and therefore costs of producing the revenue stream from the receivables.

4. Refining Treatment of Administration Costs

Both the SPV's authority to control the administration of the receivables and its actual control over the receivables are possible factors in the determination of the transaction as a true sale. By emphasizing not only authority but also actual control over the collection process, the courts create pressure for additional transaction costs in asset securitization. The SPV is created specifically for the structured financing, and it does not engage in any other forms of business. Requiring the SPV to collect the funds places pressure on originators to create transaction-specific infrastructure, increasing the transaction costs of asset securitization. Additionally, the originator would have to transfer records of the receivables to the SPV. Not only is this costly in terms of the transfer, it also introduces greater risks of error in the data. In contrast, the originator probably has already developed the infrastructure to collect the receivables (or at the very least, an operation for the collection process). More importantly, the originator already has acquired knowledge concerning the receivables.

The judicial emphasis on the SPV's authority and control over the administration of the receivables is therefore logically inconsistent. Authority is the SPV's ability to determine how the receivables should be processed, which includes the ability to determine what entity processes the receivables. The judicial requirement that the SPV have full authority over the administration process requires that the SPV have complete power in determining the agent for collection. Yet, the courts simultaneously place a premium on the SPV actually servicing the receivables. This emphasis reduces the authority that the SPV has over the administration of the receivables because it limits the SPV's ability to assign the collection

162 Schwarcz, Parts, supra note 9, at 148; Marsha E. Simms, Asset Securitization, 739 PLI/COMM 321, 332 (1996).
163 Schwarcz, Alchemy, supra note 3, at 138.
164 Schwarcz, Parts, supra note 9, at 148; Simms, supra note 162, at 332.
process to the originator. The concurrent emphasis on both authority and control is incoherent.

Common sales practice favors reconciling this tension by eliminating the control requirement. Dominion over property is usually considered a sign of ownership. Thus, transfer of dominion would be a sign of a true sale. Yet, dominion is not so much actual control as it is authority over control. An individual may assign agents to manage assets while still owning the assets. Perhaps the most prominent example of this scenario is corporate management. A corporation, as a nexus of contracts, cannot manage its own assets. It is incapable of control over the assets, and it must rely on management to control the assets. However, corporations still own assets. Thus, authority over the disposition of the asset is the true indicator of ownership while control is irrelevant.

Courts should insist that the SPV have authority to determine the collection process, but they should also recognize that control over the collection process is unnecessary. This eliminates the transaction costs associated with providing the SPV with the capability and data to collect the receivables. At the same time, the insistence on authority is sufficient to differentiate a true sale from a secured loan.

D. Contextualizing the True Sale Requirement

Taken at face value, the elements of the True Sale requirement are oddly draconian. However, understanding the True Sale requirement in light of the basic purpose of the courts provides a possible explanation. In shaping the True Sale requirement, the courts were only concerned with the authenticity of the transfer from the originator to the SPV on an intermediary level. The fundamental concern was to ensure that the securitized assets did not actually represent a secured loan. Mapping the True Sale requirements against the traits of secured debt is illustrative.

Figure 8 illustrates that the True Sale requirement is best understood not so much as a crystallization of the dimensions of a normal sale, but as a reaction against secured loans. Whereas the True Sale requirement shares some properties with the traits of normal sales, every factor of the True Sale requirement is directly opposed to the corresponding element in a secured loan. Although never explicitly mentioned, this indicates that the courts’ stringent requirements for a true sale are not aimed at ensuring that the transaction has the substance of a sale but rather that the transaction lacks the traits of a secured loan. Where secured debt and sales share traits (such as recourse), and even where they only seem to share

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traits (such as retroactive pricing), the True Sale requirement abandons faithfulness to normal conventions of sales in order to bar the offensive similarity to secured debt. The True Sale requirement would be better named the “Not Secured Debt” requirement.

From a jurisprudential perspective, judicial over-exuberance in policing secured debt in the clothing of securitized assets creates an irreconcilable schism between the treatment of sales in the context of structured financing and the treatment of sales in all other contexts. By the

Figure 8

<table>
<thead>
<tr>
<th>Transaction</th>
<th>Recourse</th>
<th>Retained Rights</th>
<th>Pricing</th>
<th>Administration</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sale</td>
<td>Yes – if there is a warranty. No – if there is no warranty.</td>
<td>None.</td>
<td>Retroactive pricing based on quality of the good is permissible.</td>
<td>Buyer may request that Seller continues to administer the merchandise.</td>
</tr>
<tr>
<td>Secured Loan</td>
<td>Yes.</td>
<td>Yes.</td>
<td>May be indexed to certain financial indicators.</td>
<td>Debtor employs collateral during the term of the loan.</td>
</tr>
<tr>
<td>True Sale</td>
<td>No.</td>
<td>No.</td>
<td>No pricing adjustments.</td>
<td>Seller may not administer the purchased property.</td>
</tr>
</tbody>
</table>

This figure compares the characteristics of a normal sale, a secured loan and a “True Sale” required by courts in structured financing along the four factors constituting the True Sale requirement.

standards of the True Sale requirement, each sale by Dell Computer Corporation of a personal computer is susceptible to attack for actually being a secured loan because the buyer automatically acquires a limited warranty. Moreover, every purchase from Buy.com would falter under the shadows of the True Sale requirement because of Buy.com’s thirty-day pricing guarantee, which retroactively adjusts the price of a purchase in response to price shifts in the industry. Harkening back to the

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167 For details of Buy.com’s pricing guarantee, see http://www.us.buy.com/corp/support/guarantees/lowpriceguarantee.asp.
Opponents' attack on floating liens, the True Sale requirement requires too much. In attempting to attack every trace of a security interest in securitized assets, the True Sale requirement invalidates a significant portion of innocuous sales. Unless the courts simply assert a different treatment for sales in the context of structured financing as opposed to all other contexts, the True Sale requirement must be refined to accommodate recourse, retroactive pricing tied to the quality of the nature of the receivables, and full SPV autonomy in administration of the receivables.

A deeper similarity between the Opponents' treatment of floating liens and the current judicial disposition to structured financing is the reasoning that substantiates each party's overly broad attack. The Opponents' different treatment of economically identical value streams with respect to fluid assets on the one hand and static assets on the other hand was motivated by an unrefined reliance on common notions of individuation. The development of the True Sale requirement evidences a similar dependence on nominal differentiations. Ironically, in attempting to discern the substance in various structured financings, the courts may have implicitly invoked the form of exchanges between the originator and the SPV in shaping the True Sale requirement. A plausible reason as to why the contradiction involved in barring recourse in asset securitization but permitting full warranties in everyday sales escaped the courts is because warranties involve servicing or replacing merchandise, a muted expression of transfer of value, whereas recourse in asset securitization takes the form of payments from the originator to the SPV, a blatant example of exchange of value. Of course, warranties and recourse have identical economic substance. Once the courts' analysis is purged of these purely nominal distinctions, differences between a True Sale in structured financing and conventional sales evaporate.

Finally, the courts' severe demands of a sale in the context of asset securitization could express an inchoate hostility to floating liens and similar instruments inherited from the Bankruptcy Code's blanket prohibition on floating liens and their unresolved judicial status of floating liens. A rigorous analysis of such a suspicion demonstrates, however, that it is unfounded. While floating liens present unique and significant challenges to effective regulation, transporting judicial doubts on floating liens to securitized assets ignores the fundamental structural differences between the two forms of financing. Indeed, asset securitization represents an ideal vehicle for the use of fluid assets in raising capital not only because of its economic benefits, but also because it solves the problems associated with policing fluid assets.

The actual problem with fluid assets is the opacity of their content, which raises justified concerns about the courts' ability to police liens on fluid assets. This opacity stems from the fact that the content of the fluid
asset is linked to the nature of the debtor’s business. In the case of structured financing, the purpose of the entire enterprise is to divorce the fluid asset, the receivables, from the identity of the originator. This creates an economic benefit of reducing the cost of capital; however, it also inadvertently creates the jurisprudential benefit of conceptually collapsing securitized fluid assets and static assets. By separating the fluid asset from the originator, structured financing purges the fluid asset of its impenetrable, radical dynamism and provides it with fixed and easily determined boundaries. Securitizing fluid assets effectively deadens them by removing them from the source of their radical dynamism—their link to the debtor’s business. Asset securitization does not deserve the judicial skepticism surrounding floating liens because it answers the conceptual opacity of fluid assets by severing the ties between the originator and the receivables.

Conclusion

The controversy surrounding floating liens and structured financing is the product of an inaccurate assessment of the problems created by each financial vehicle. More importantly, the misconceptions and misdirections in the jurisprudential history of floating liens and asset securitization have arisen primarily from a naked reliance on conventional notions of unity and value. Floating liens require the perspective provided by the Revised Transfer Intuition rather than the original Transfer Intuition. Asset securitization is best regulated by a more complete and realistic notion of a true sale. A thoroughly Heraclitean view of assets provides the Bankruptcy Code and bankruptcy courts with the conceptual machinery to address both of these essential financial vehicles. On a more general level, courts must develop greater sensitivity to the underlying economics animating the instruments under their scrutiny. Realizing the inherent dynamism of all assets not only unifies the treatment of all types of assets, it also produces the practical benefit of significantly reducing transaction costs with various forms of secured financing while preserving the distinctions established by policy makers.