Bankruptcy Preference Concerns in Industrial Development Bond Financing

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This article suggests several methods by which investors in industrial development bonds may be protected, in the event of the bankruptcy of the corporate borrower, from the preferential transfer rules of the federal bankruptcy laws. The key to protecting the investors from having payments made to them set aside by the bankruptcy trustee as voidable preferences is shown to lie in the structuring of the bond transaction. The authors indicate how proper structuring of the bond transaction may allow investors to keep pre-bankruptcy payments made by the corporate borrower, while doing no violence to the terms of section 547 of the Bankruptcy Reform Act. By reducing preference risks to these investors, the use of industrial development bonds is encouraged, and the salutary effect they have on the economy promoted.***


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*** Ed.
I. INTRODUCTION

The use of tax-exempt financing to generate capital has become an increasingly important aspect of corporate finance. The major appeal of this type of financing is reduced interest cost. Because income to the holder of tax-exempt obligations is exempt from federal income taxation, tax-exempt financing

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2 Although lower interest rates are the major appeal of tax-exempt financing, there are other key advantages. Such financing is also frequently exempt from state and local income taxation. Additionally, in contrast to most corporate securities offerings that require extensive measures to satisfy the registration requirements of the Securities and Exchange Commission (the "SEC") under the Securities Act of 1933, 15 U.S.C. §§ 77a-77bbbb (1976), § 3(a)(2) of the Securities Act of 1933 (current version at 15 U.S.C. § 77(a)(2) (1977)) provides that certain tax-exempt bonds issued on behalf of companies are exempt from SEC registration. They are also exempt in many instances from state registration requirements under specific state "blue sky" laws. See, e.g., Ga. Code Ann. § 97-108(a) (1981); W. Va. Code § 32-4-402(a)(1) (1982 Repl. Vol.). These benefits are currently available without the loss of other tax advantages, such as the investment tax credit, I.R.C. § 38 (1976), and accelerated depreciation, I.R.C. § 167 (1976). The energy tax credit I.R.C. § 38 (Supp. III 1979), however, is reduced from 10% to 5% if the equipment qualifying for the energy tax credit is financed with tax-exempt bonds. I.R.C. § 46 (1981).

3 I.R.C. § 103(a) (1976) provides that interest income on the obligations of a state, territory or possession of the United States, or any political subdivision thereof, is exempt from federal income taxation. Since April 30, 1968, however, I.R.C. § 103(b) (1976) has governed the tax exemption on "industrial development bonds." In general, industrial development bonds are obligations issued for private industrial and commercial development. The term "industrial development bond" is defined at I.R.C. § 103(b)(2):

(2) Industrial development bond.—For purposes of this subsection, the term "industrial development bond" means any obligation—

(A) which is issued as part of an issue all or a major portion of the proceeds of which are to be used directly or indirectly in any trade or business carried on by any person who is not an exempt person (within the meaning of paragraph (3)), and

(B) the payment of the principal or interest on which (under the terms of such obligation or any underlying arrangement) is, in whole or in major part—

(i) secured by any interest in property used or to be used in a trade or business or in payments in respect of such property, or

(ii) to be derived from payments in respect of property, or borrowed money, used or to be used in a trade or business.

An "exempt person" is defined in I.R.C. § 103(b)(3) to include a government unit. I.R.C. § 103(b) further provides that interest on an industrial development
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typically bears a rate of interest significantly below the rate of interest payable on otherwise comparable corporate debt instruments. Debt instruments used to provide tax-exempt monies for the benefit of private corporations are a form of municipal bond commonly referred to as industrial development bonds will qualify for federal tax-exempt status only if substantially all of proceeds are to be used for certain exempt facilities, see I.R.C. §§ 103(b)(4)-(5) (1981), or if the size of the IDB issue is less than $1,000,000. I.R.C. § 103(b)(6)(A) (1980). Under certain conditions, the $1,000,000 limit can be raised to $10,000,000 by an election of the bond issuer. I.R.C. § 103(b)(6)(D) (1981). When the election is made, not only is the face amount of the bond issue included in the $10,000,000, but certain capital expenditures by the company using bond proceeds during a period beginning 3 years prior to and ending 3 years after the date of issuance will also count toward the $10,000,000 limit. I.R.C. §§ 103(b)(6)(E)-(F). For an analysis of the federal tax exemption as it pertains to the $1,000,000 limitation on industrial development bonds, see Cook & Safranek, Related Persons, Partnerships and the $10 Million Small Issue Exemption, 2 Mun. Fin. J. 253 (1981); Wade, Industrial Development Bonds—The Capital Expenditure Rule for $10,000,000 Small Issues, 34 Bus. Law. 1771 (1979); Podolin & O'Leary, Capital Expenditure Problems under the Ten Million Dollar Exemption for Industrial Development Bonds, 33 Tax Law. 153 (1979).

1 Industrial development bonds will normally bear a rate of interest ranging from 2 to 3.5 percentage points (200 to 350 basis points) below the rate of interest payable on otherwise comparable corporate debt instruments.

2 There are at least two broad classifications of municipal bonds—general obligation bonds and revenue bonds. General obligation bonds are obligations backed by the full faith and credit (i.e., taxing power) of the entity that is the issuer of the bonds. In other words, the issuing governmental entity has the power to levy additional taxes to pay principal and interest due on general obligation bonds. General obligations bonds often require voter approval prior to their issuance. See, e.g., Allison v. Phoenix, 44 Ariz. 66, 33 P.2d 927 (1934); Davis v. Pueblo, 158 Colo. 319, 406 P.2d 671 (1965); Tracy v. Barnes County, 69 N.D. 602, 289 N.W. 377 (1939); Phillips v. City of Rock Hill, 188 S.C. 140, 198 S.E. 604 (1938).

Revenue bonds, on the other hand, generally are not considered to constitute a liability of the issuer because they are not secured by the credit of the issuer. See, e.g., State v. City of Tampa, 138 Fla. 840, 183 So. 491 (1933); Button v. Day, 203 Va. 687, 130 S.E.2d 459 (1963). Instead, revenue bonds are payable only from a special fund, such as the revenues of the particular project or facility that is being financed by the bond proceeds. See, e.g., Perl-Mack Civic Assoc. v. Board of Directors, 140 Colo. 371, 344 P.2d 685 (1959). Hence, revenue bonds as a general rule do not require voter approval as a condition to their issuance. See, e.g., Clover Leaf, Inc. v. City of Jackson, 145 Fla. 341, 199 So. 923 (1940); See also Davis v. Pueblo, 158 Colo. 319, 406 P.2d 671 (1965). Revenue bonds traditionally have been issued to finance such public revenue generating projects as sewer systems, gas service, parking facilities, ports, rapid transit systems, toll roads, bridges, stadiums, and solid waste disposal systems. In recent years revenue bonds have been issued to finance local public housing projects.

Industrial development bonds (IDBs) are a species of municipal revenue bonds. Like other forms of municipal revenue bonds, IDBs do not constitute an
bonds, and will be referred to in this article as "IDBs."


For a discussion of all aspects of municipal bond financing, see R. Lamb & S. Rapport, Municipal Bonds (1980) (in which the authors describe the IDBs as "corporate bonds disguised to look like municipal bonds").

Although there may be an historical basis for the distinction, in common parlance the terms "industrial development bonds" and "industrial revenue bonds" are used interchangeably and have the same meaning. See Congressional Budget Office, Small Issue Industrial Development Bonds 1 n.1 (April 1981).

IDBs had their genesis in the State of Mississippi. In 1936, an industrial development program in that state, entitled "Balance Agriculture with Industry," authorized the first IDB issue in the United States. For a detailed discussion of the original Mississippi legislation, see Abbey, Municipal Industrial Development Bonds, 19 Vand. L. Rev. 25, 27-28 (1965). Other states, particularly in the Southeast, developed similar programs, the main intent of which was to strengthen and stimulate the sagging economy of these primarily agricultural states by attracting industry away from the northeastern United States. See Note, Municipal Subsidies and the Industrialization of the South, 47 Yale L. J. 1412 (1938). By 1960, 16 other states had followed Mississippi's lead and had enacted legislation permitting the issuance of IDBs. At least 40 states had enacted such legislation by 1968. See Mitchell v. North Carolina Indus. Dev. Fin. Auth., 273 N.C. 137, 159 S.E.2d 745 (1968). Today IDBs are permissible in some form in all but 3 states—Washington, Idaho and Hawaii. (Idaho and Hawaii permit the issuance of IDBs to finance pollution control facilities, although Idaho requires voter approval.)

For a thorough discussion of the background and development of IDBs, see Falk, Some Legal and Economic Aspects of Industrial Development Financing, 22 Vand. L. Rev. 159 (1968).

As the following table illustrates, the volume of IDBs has increased steadily during the past decade:

<table>
<thead>
<tr>
<th>Year</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1971</td>
<td>$219,510,000</td>
</tr>
<tr>
<td>1972</td>
<td>470,695,000</td>
</tr>
</tbody>
</table>
means of generating capital to acquire and construct a new facility, renovate or expand an existing facility or purchase machinery and equipment for use by a private entity in its business. With the increased use of IDB financing has come an in-

<table>
<thead>
<tr>
<th>Year</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1973</td>
<td>269,762,000</td>
</tr>
<tr>
<td>1974</td>
<td>339,970,000</td>
</tr>
<tr>
<td>1975</td>
<td>517,801,000</td>
</tr>
<tr>
<td>1976</td>
<td>356,909,000</td>
</tr>
<tr>
<td>1977</td>
<td>463,816,000</td>
</tr>
<tr>
<td>1978</td>
<td>586,076,000</td>
</tr>
<tr>
<td>1979</td>
<td>1,339,890,000</td>
</tr>
<tr>
<td>1980</td>
<td>1,485,731,000</td>
</tr>
</tbody>
</table>

*Does not include IDBs issued to finance pollution control facilities.


* I.R.C. § 103(b)(6)(A)(1981) and the Treasury Regulations promulgated thereunder provide that IDB proceeds can only be expended for the acquisition, construction, reconstruction, or improvement of land or property qualifying for the allowance for depreciation, or for payment of amounts which are for federal income tax purposes chargeable to the project's capital account or which would be so chargeable either with a proper election (for example, under I.R.C. § 266) or but for a proper election to deduct such amounts.

State law governs the nature of the project that can be financed. As initially conceived, IDBs were to be used solely for industrial projects. See Note, Municipal Subsidies and the Industrialization of the South, 47 YALE L. J. 1412 (1938); Note Incentives to Industrial Relocation: The Municipal Industrial Bond Plans, 66 HARV. L. REV. 898 (1953). A growing number of states, however, have enacted or amended legislation to permit the financing of commercial facilities with IDBs. The Congressional Budget Office reported that as of 1980 IDBs were available for commercial projects in 26 states. CONGRESSIONAL BUDGET OFFICE, SMALL ISSUE INDUSTRIAL DEVELOPMENT BONDS (April 1981). Various state courts have specifically upheld the use of IDBs to finance commercial projects. See, e.g., Jordon v. Industrial Dev. Auth., Inc., 570 S.W.2d 666 (Mo. 1978); Grossman v. Herkimer County Indus. Dev. Agency, 60 A.D.2d 172, 400 N.Y.S.2d 623 (N.Y. App. Div. 1977); Small World, Inc. v. Industrial Dev. Bd. of Tullahoma, 553 S.W.2d 596 (Tenn. Ct. App. 1976); State ex rel. Ohio County Comm'n v. Samol, 275 S.E.2d 2 (W. Va. 1980); See also White, Revenue Bonds for Commercial Development in West Virginia, 83 W. VA. L. REV. 67 (1990).

creased concern by investors, as well as by bond rating agencies called upon to assess the risk to investors, of the consequences of the bankruptcy of the issuer or the company for whose benefit the IDBs are issued. In particular, questions are being raised concerning the risk that pre-bankruptcy payments to the holders of IDBs might be recoverable from them as voidable preferences under the federal bankruptcy laws.

The Bankruptcy Reform Act of 1978 was passed by the Congress on October 6, 1978, and signed into law by President Carter on November 6, 1978. Title I of the Reform Act, which consists only of Section 101, enacts the substantive law of bankruptcy and codifies that law as Title 11 of the United States Code (hereinafter the “Code”). Section 547 of the Code sets forth the law relating to pre-bankruptcy transfers of a debtor's property that may be set aside in bankruptcy and recovered as preferences from the transferee creditors. The Code generally ap-


The Oversight Subcommittee of the House Ways and Means Committee held hearings on IDBs during the Spring of 1981. See "Small Issue" Industrial Development Bonds: Hearings Before the Subcommittee on Oversight of the Committee on Ways and Means, 97th Cong., 1st Sess. (1981). On January 27, 1982, the Reagan Administration unveiled its proposal to curb the use of IDBs. For a summary of the provisions of that proposal see Gleckman. IDB Curbs Bared; Minimum Tax Seen on Bond Interest, The Bond Buyer, Jan. 28, 1982, at 1. It is anticipated that some change in the federal legislation granting tax-exempt status to IDBs will occur during the current session of Congress.

The concern perhaps arises from the alarming increase in the incidence of bankruptcies. In the first 10 months of 1981, for example, approximately 14,500 businesses filed for bankruptcy, which represented a gain of better than 42% over 1980 filings. See New York Times, Nov. 15, 1981. The rate now exceeds 50 filings per 10,000 active businesses, which surpasses the rate of the 1970 and 1974 recessionary periods. Id. Bankruptcy filings in the automotive industry alone have risen by 96%, and consumer bankruptcies have dramatically increased from fewer than 180,000 filings in 1978 to a record 450,000 in fiscal 1981. Id. See also WASH. FIN. REP. (BNA) No. 44, at A-10 (Nov. 9, 1981).


12 The Bankruptcy Reform Act constitutes the fifth bankruptcy law of the United States and represents the first major revision of the federal laws relating to bankruptcy since the enactment of the Chandler Act, 52 Stat. 883 (1938). The Act was promulgated under Congress' power to enact uniform laws on the subject of bankruptcies. U.S. CONST., art. I, § 8, cl. 4.

plies to all bankruptcy cases filed on or after October 1, 1979, which is the date on which the former Bankruptcy Act was repealed. Accordingly, even though an IDB financing was concluded prior to this effective date, payments to the holders of the IDBs will be subject to the preference provisions of section 547 in a bankruptcy case commenced on or after October 1, 1979.

This article will first discuss the typical structure of an IDB financing and the participants in such a financing. Thereafter, the article will analyze the potential for preference recovery from investors in IDBs and like concerns of other participants in the financing. Finally, the article will identify some recent innovations designed to insulate IDB investors from section 547 recovery and will assess the efficacy of these innovations.

II. STRUCTURE OF AN IDB FINANCING

A. Participants in an IDB Financing

The participants in a typical IDB transaction include the issuer of the bonds (hereinafter the "issuer"); the private, for-profit entity that will ultimately be the beneficiary of the bond proceeds (hereinafter the "company"); the purchasers of the IDBs (hereinafter the "bondholders"); and an institutional fiduciary to serve as bond trustee (hereinafter the "bond trustee").

16 This article is concerned with voidable preferences under § 547 of the Code. It does not examine the trustee's avoidance powers under § 544 ("strong arm" powers), § 548 (fraudulent conveyances), § 549 (invalid post-petition transfer), or § 553 (limitation on the right to set-off mutual debts).
17 Depending on the complexity of the financing, various other participants may also be involved, including investment bankers, feasibility consultants, and accountants. In addition, bond counsel, generally a firm of attorneys with nationally recognized expertise in the area of municipal bond law, will be employed to opine that the IDBs have been legally issued and that interest on the IDBs will be exempt from federal income tax and, where applicable, from state income tax. An opinion of bond counsel is routinely required by the underwriter or other purchaser of IDBs. Bond counsel has responsibility for the preparation of the legal documents relating to the issuance of the IDBs. For a discussion on the role of bond counsel, see Skees, Role of Bond Counsel: The Need for Definition, 1 Mun. Fin. J. 199 (1980).
1. **Issuer.** In order for interest on IDBs to be tax-exempt, the issuer must qualify under federal law as an entity whose debt obligations are exempt from federal taxation.\(^{18}\) Although it is not uncommon for cities or counties, or even states, to act as issuers, perhaps the most typical issuers are industrial development authorities. These authorities are public entities created by state law. They are empowered to issue debt obligations in order to accomplish some public purpose, such as the stimulation of economic development and the promotion of employment opportunities within their respective jurisdictions.\(^{19}\)

IDBs are typically nonrecourse debt obligations of the issuer. Under the laws of most states, the issuer is obligated to repay IDBs solely from the revenues it derives from the company in connection with the facility being financed. Except to the extent of making those revenues available to the bondholders, the issuer has no pecuniary liability whatsoever, and therefore, the IDBs are without recourse to the issuer.\(^{20}\) In a

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\(^{18}\) I.R.C. § 103 (1976). *See supra* note 3 and accompanying text.


\(^{20}\) State laws permitting the issuance of IDBs require in substance that IDBs cannot be deemed to constitute a debt, liability, or obligation, or a pledge of the faith and credit of the issuer, the state in which the issuer exists, or any political subdivision of that state. The bonds may be payable only from the revenues and other amounts derived by the issuer under the financing agreement and other security specifically pledged for the payment of the IDBs; *see infra* note 29 and accompanying text. *See, e.g.*, W. VA. CODE §§ 13-2C-7 to -8 (1974 Repl. Vol.). The holder of an IDB cannot look to or compel the exercise of the taxing power of the
typical IDB financing, the issuer is merely a conduit and assigns all of its rights and interests created by the documents executed in connection with the issuance of the IDBs to the bond trustee for the benefit of the bondholders.\textsuperscript{21} After the issuance and sale of the IDBs, the issuer's role is generally passive. The primary significance of the issuer in an IDB financing, therefore, is that interest income to the bondholders on IDBs issued by it is exempt from federal taxation, whereas interest income to holders of bonds issued directly by the company would be subject to taxation.

2. \textit{Company.} The proceeds from the sale of the IDBs are used to acquire, construct, renovate or improve certain real or personal property (hereinafter the “project”). The company dictates the requirements, plans and specifications of the project, often without input from or supervision by any of the other participants in the financing.\textsuperscript{22} The company agrees with the issuer to pay amounts sufficient to satisfy, when due, the principal amount of and interest accruing on the IDBs, and to pay the contractual fees and expenses of the issuer and the bond trustee.\textsuperscript{23}

3. \textit{Bond Trustee.} As previously mentioned, the issuer in an IDB financing will generally assign all of its rights and interests in the financing to the bond trustee for the benefit of the bondholders. The bond trustee, therefore, collects the amounts due from the company and administers the remittance of those amounts to the bondholders as payments of principal and interest. The bond trustee is charged with the responsibility to enforce the legal and equitable remedies available to it in the event of a default by the company.\textsuperscript{24} In effect, the bond trustee

\begin{itemize}
  \item[21] The assignment is usually made in the “indenture of trust.” \textit{See infra} note 30 and accompanying text.
  \item[22] In financings where the bondholders are sophisticated investors and limited in number, the documentation may provide that the plans and specifications are subject to their approval. In some cases the approval of an independent architect or engineer is required before any IDB proceeds can be applied to pay the costs of acquisition and construction of the project. \textit{See infra} note 29.
  \item[23] The responsibilities of the bond trustee are set forth in a document that is referred to as the “indenture of trust.” \textit{See infra} note 30, and accompanying text.
\end{itemize}
steps into the shoes of the issuer in an IDB financing, and is empowered as assignee of the issuer's rights to enforce payment and collection from the company for the bondholders' benefit.

4. **Bondholders.** IDBs are traditionally marketed in one of three ways: publicly, privately or in a limited institutional offering. Purchasers of IDBs normally include casualty and life insurance companies, commercial banks, certain savings and loans, bond funds and individuals.\(^{25}\) Purchasers have their own investment requirements and preferences and each varies in the degree of sophistication and expertise brought to the process of investing in corporate debt obligations.

Although the interest yield on tax-exempt securities is lower in absolute terms than that on corporate bonds, it is usually higher on a net after-tax basis because of the exemption from federal, and often state and local, income tax. Thus, investors in most tax brackets may receive greater return from tax-exempt investments, including IDBs, than on an after-tax basis from other comparable investments.\(^{26}\)

**B. Basic Documentation in a Typical IDB Financing**

1. **Financing Agreement.** Although they may take many forms, IDB financings have traditionally been structured either as a lease or as a sale.\(^{27}\) The issuer and the company enter into a

\(^{25}\) In 1980, commercial banks became the mainstay of the municipal bond market. Banks acquired $9.9 billion of new municipal issues in 1980, including a substantial number of IDBs. Casualty insurance companies, formerly the principal buyers, accounted for some $8 billion of purchases. *See* The Daily Bond Buyer, Oct. 14, 1980 at 1. The Federal Reserve Board reported, however, that individuals bought three-quarters of the new issues of tax-exempt securities during the first 9 months of 1981, taking the lead from commercial banks. *See* The Daily Bond Buyer, Dec. 15, 1981 at 1. Experts predict, however, that casualty insurance firms may resume a significant role as investors in tax-exempt securities by late 1982. *See* The Daily Bond Buyer, Jan. 7, 1982 at 1.

\(^{26}\) For a married couple filing a joint return for 1981 with a combined income of $24,600 to $29,900 (29% tax bracket), a 10% tax-exempt bond is equivalent, after taxes, to a taxable return of 14.08%. The results are more dramatic as the taxpayer's tax bracket increases. For example, if this same couple had a taxable income in excess of $60,000 (49% tax bracket), an equivalent taxable issue would have to yield 19.61%. *See* [1982] STAND. FED. TAX REP. (CCH) ¶ 278.10

\(^{27}\) For a discussion of the lease agreement and other legal documentation supporting an issue of IDBs, see Abbey, *Municipal Industrial Development Bonds*, 19 VAND. L. REV. 25 (1965).
lease agreement or an agreement of sale pursuant to which the issuer agrees to use the IDB proceeds to acquire and construct the project and to lease or sell the project to the company. The issuer, in turn, grants to the company full power and authority to acquire and construct the project in accordance with the company's requirements and specifications. When a lease agreement is used, the company is obligated, upon termination of the lease, to purchase the facility for a nominal price.

Recent enabling legislation in many states permits the issuer to lend the proceeds from the sale of the IDBs directly to the company pursuant to a loan agreement. When a loan is permissible, the pretense of having the issuer construct the facility is unnecessary and at all times during the term of the financing the facility is owned by the company. The lease agreement, agreement of sale or loan agreement, as the case may be (hereinafter the "financing agreement"), requires the company to make payments to the issuer in amounts necessary to pay debt service on the IDBs together with any incidental fees and expenses of the issuer and trustee.

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28 Thirty-seven states now permit the structuring of an IDB financing as a loan of the proceeds by the issuer to the company. The 13 states that prohibit such a loan are Alabama, Hawaii, Kansas, Louisiana, Michigan, Mississippi, Nebraska, New Mexico, North Dakota, Oklahoma, Pennsylvania, South Dakota and Virginia.

29 Payment language in a representative financing agreement provides:

Section ________ Amounts Payable.

(a) The company hereby covenants and agrees to pay the purchase price [make lease payments] [repay the loan] in installments, as follows: on or before five (5) business days prior to any interest payment date for the bonds, such being __________ and __________ of each year commencing __________, 198__, or any other date fixed for redemption of any or all of the bonds pursuant to the indenture, until the principal of, premium, if any, and interest on the bonds shall have been fully paid or provision for the payment thereof shall have been made in accordance with the indenture, in immediately available funds, a sum which, together with other moneys available therefor, will enable the bond trustee to pay the amount payable on such date as principal of (whether at maturity or upon redemption or acceleration or otherwise), premium, if any, and interest on the bonds as provided in the indenture.

(b) The company will also pay upon demand the reasonable expenses of the issuer related to the issuance of the bonds.

(c) The company will also pay the reasonable fees and expenses of the bond trustee.
2. **Indenture of Trust.** In addition to the financing agreement, the issuer will enter into an indenture of trust (hereinafter the "indenture") with the bond trustee. The indenture provides that all of the issuer's rights and interests in the financing agreement, including the right to collect payments thereunder, are assigned to the bond trustee. Moreover, the indenture will set forth all of the terms and conditions of the IDBs, such as provisions concerning redemption, interest rate and maturity. It will further specify the rights, duties, and remedies of the bond trustee.30

**C. Security for Payment of the IDBs**

IDBs are primarily secured by an assignment of the revenues payable to the issuer by the company under the financing agreement. These payments under the financing agreement are assigned by the issuer to the bond trustee pursuant to the indenture and, in fact, are generally paid by the company directly to the bond trustee for remittance to the bondholders.31 In addition to the pledge of revenues, two other security devices are typically found in an IDB financing—a mortgage on the project and a guaranty of payment from a third party.

1. **Mortgage.** IDBs are routinely secured by granting a mortgage32 upon that portion of the project consisting of real

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30 The indenture normally will permit the bond trustee to exercise various remedies against the company upon the occurrence of specified events of default under the indenture or the financing agreement. If the default results from the failure to make a required payment, the bond trustee is generally required to exercise its remedies. Remedies normally include the right to accelerate the indebtedness represented by the IDBs and to declare all outstanding principal and the interest due thereon immediately due and payable.

31 The company's recognition of the assignment by the issuer of the amounts payable under the financing agreement, and the company's agreement to pay such amounts directly to the bond trustee, may take the following form:

   It is understood and agreed that all payments payable under this section by the company are assigned by the issuer to the bond trustee for the benefit of the bondholders. The company assents to such assignment. The issuer hereby directs and the company hereby agrees to pay to the bond trustee . . . all payments payable by the company pursuant to this section.

32 State law will dictate the form of lien that will be taken in the project. For example, in Georgia, a "deed to secure debt" may be the vehicle preferred over a mortgage, and in West Virginia the preferred vehicle may be a "deed of trust."
property and by a security interest in that portion of the project consisting of personal property. Depending on the specific structure of the financing, the mortgagor may be either the issuer or the company and the mortgagee may be either the issuer or the bond trustee. Where the mortgagor is the company and the mortgagee is the issuer, the rights and interests of the issuer in the mortgage are assigned to the bond trustee in the same manner as the issuer's rights and interests in the financing agreement are assigned.

2. Guaranty. A second common method of enhancing the security of IDBs is an unconditional guaranty of payment of the IDBs or the financing agreement, or both, which is obtained from a parent or affiliate of the company. Although the specific terms of a guaranty agreement will vary, the guarantor at a minimum agrees to pay to the bond trustee for distribution to the bondholders amounts necessary to satisfy the unpaid principal and interest due on the IDBs if the bond trustee has insufficient funds available to make those payments. The guarantor ordinarily covenants to honor the guaranty without the requirement that the bond trustee first exhaust other available remedies. As a result, the bondholders may look not only to the credit of the company that will use the proceeds derived from the sale of the IDBs, but also to the credit of a financially strong parent or affiliate of the company.

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53 Section 5 of the Securities Act of 1933 (current version at 15 U.S.C §§ 77a-77bbbb (1976)) makes it unlawful for any person to offer or sell securities in interstate commerce or through the mails, unless a registration statement has been filed with the SEC and the purchaser/offeree has been provided with a prospectus meeting the requirements of § 10 of that Act. Section 3(a)(2) (current version at 15 U.S.C. § 77(a)(2) (1977)) exempts "any security which is an industrial development bond." See supra note 3. It is generally accepted, and the SEC has issued "no action" letters to the effect that, this exemption not only extends to the IDBs themselves, but also to the other integral parts of the exempted IDBs, including underlying agreements such as a guaranty. See, e.g., Hopewell Convalescent Center [1977-78 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81, 292; McDonald's Corp. [1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 76, 336. In certain cases, however, particularly where the guarantor under the guaranty is not related to the company and is not a user of the project, the SEC has declined to issue no-action letters with respect to the exemption of the guaranty from registration, and has indicated that such a guaranty may be subject to registration requirements despite the exemption applicable to the IDBs themselves. See, e.g., County of Yellowstone [1976-77 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 60, 719.
III. ANALYSIS OF THE BANKRUPTCY PREFERENCE PROBLEM

A. Overview of Preferences

A principal goal of the preference provisions of the Code is the assurance of equal distribution of the debtor's assets among its creditors and the prevention of favoritism. As will be discussed below, a preference that is voidable in bankruptcy consists of seven distinct elements. Each of these elements must be shown to exist before the alleged preferential transfer may be set aside.

The drafters of the Code gave these reasons for the need for effective preference provisions in the Code:

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


It should be noted that, until the commencement of a bankruptcy case, a debtor has the right to dispose of his property and to prefer one creditor over another provided that the disposition is not otherwise violative of federal or state law. Johnson-Baillie Shoe Co. v. Bardsley, 237 F. 763 (8th Cir. 1916). As noted by the court in Canright v. General Fin. Corp., 35 F. Supp. 841, 843-44 (E.D. Ill. 1940), aff'd, 123 F.2d 98 (7th Cir. 1941):

A voidable preference under the Bankruptcy Act does not involve any fraudulent intent. Indeed, in the absence of the bankruptcy law, a diligent creditor may lawfully retain a preference... But the purpose of the Bankruptcy Act is to bring about equality of division of assets among creditors. For the rule that to the diligent creditor belongs the reward, the act substitutes the rule that equality is equity.

The preference provisions of section 547 apply in liquidation cases commenced under Chapter 7 of the Code, 37 in reorganization cases commenced under Chapter 11 of the Code, 38 and in municipal debt adjustment cases commenced under Chapter 9 of the Code. 39 In a Chapter 7 case, the duly appointed trustee in bankruptcy of the debtor's estate will be the party asserting preference claims. 40 In Chapter 11 cases the debtor normally remains in possession of his assets 41 and is known as the debtor in possession. 42 He will be the party asserting the preference 43 unless a trustee is appointed by the court for cause on the request of a creditor or other interested party. 44 In Chapter 9 cases, the municipality has the proper standing to bring preference claims, but a trustee may be appointed for that purpose at the request of an interested party if the municipality declines to assert the preference. 45 For purposes of this article, the party asserting the preference will be referred to as the "bankruptcy trustee" irrespective of the particular Chapter of the Code involved.

Section 547 of the Code sets forth the law of pre-bankruptcy transfers that are voidable by the bankruptcy trustee as so-called "preferences." A preference is defined by subsection (b) of section 547 of the Code to be:


40 A trustee is appointed as the representative of creditors of the debtor's estate in a Chapter 7 case. 11 U.S.C. § 702 (Supp. III 1979).
44 In Committee of Unsecured Creditors v. Monsour Medical Center (In re Monsour Medical Center), 5 Bankr. 715 (Bankr. W.D. Pa. 1980), the court held that when a debtor in possession unjustifiably fails to exercise its avoidance powers under § 547, the creditors' committee has the implied authority to institute an avoidance action on behalf of the debtor in possession. Contra Segarra v. Banco Cent. Y. Economias (In re Segarra), 5 COLIER BANKR. CAS. 2d 552 (Bankr. D. P.R. 1981).
a "transfer" (as defined in section 101(40) of the Code),

(2) of property of the debtor,

(3) to or for the benefit of a "creditor" (as defined in section 101(9) of the Code),

(4) for or on account of an antecedent debt owed by the debtor before such transfer was made,

(5) made while the debtor was "insolvent" (as defined in section 101(26) of the Code), the debtor being presumed to have been insolvent during the 90-day

Section 101(40) defines "transfer" to mean "every mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing with property or with an interest in property, including retention of title as a security interest." 11 U.S.C. § 101(40) (Supp. III 1979).

Section 101(9) defines "creditor" to include an "entity that has a claim against the debtor that arose at the time of or before the order for relief concerning the debtor." 11 U.S.C. § 101(9)(A) (Supp. III 1979).

Section 101(26) defines "insolvent" to mean a "financial condition such that the sum of such entity's debts is greater than all of such entity's property, at a fair valuation," exclusive of certain property fraudulently conveyed by the entity and certain property that individual debtors may exempt from the claims of their creditors under § 522 of the Code. 11 U.S.C. § 101(26)(A)(i), (ii) (Supp. III 1979). See Clay v. Traders Bank (In re Briarbrook Dev. Corp.), 11 Bankr. 515 (Bankr. W. D. Mo. 1981).

The phrase "at a fair valuation" also appeared in the definition of insolvency contained in § 1(19) of the former Bankruptcy Act. The courts in pre-Code cases construed this phrase to mean that an asset would be included in the debtor's estate for purposes of computing insolvency only if the asset had "a value that can be made promptly effective by the owner of property 'to pay his debts.'" Stern v. Paper, 183 F. 228, 230 (D.N.D. 1910), aff'd, 198 F. 642 (8th Cir. 1912). If the value of an asset is not susceptible of prompt realization, as is often the case with choses in action of a debtor, the courts have declined to attribute a value to such assets in determining whether insolvency exists. See, e.g., Penn v. Grant, 244 F.2d 309 (9th Cir. 1957) (action for usury against finance company); In re F&M Corp., 19 COLLIER BANKR. CAS. 292 (D. Kan. 1978) (breach of contract claims
period before the bankruptcy case is commenced, on or within 90 days before the bankruptcy petition is filed, that enables such creditor to receive more than he would be entitled to receive in a liquidation case under Chapter 7 of the Code if the transfer had not been made.

If the creditor receiving the challenged transfer is found to be an "insider" of the debtor, then the 90-day period referred to above is extended to include the period between 90 days and one year before the date of the filing of the bankruptcy petition. If the bankruptcy trustee seeks to avoid a transfer to an insider during this extended period, he does not have the benefit of the presumption that the debtor was insolvent during that period; he must prove that the insider had reasonable cause to believe at the time the transfer was made that the debtor was insolvent. An "insider" is defined to include a person who has a

against federal government); In re Nelly Don, Inc., 19 COLIER BANKR. CAS. 681 (W.D. Mo. 1978) (net operating loss carry forward); In re Bichel Optical Laboratories, Inc., 299 F. Supp. 545 (D. Minn. 1969) (antitrust claim).


Only reasonable cause to believe that the debtor is insolvent, and not actual knowledge, is necessary to render the transfer voidable. Loftis v. Minar (In re Montanino), 4 COLIER BANKR. CAS. 2d 362 (Bankr. D.N.J. 1981). As was stated by the court in In re Hygrade Envelope Corp., 366 F.2d 585 (2d Cir. 1966), the determination of whether a creditor had reasonable cause to believe his debtor was insolvent is a two-step process.

First, the court must determine what the creditor knew; then it must apply the rules as to the legal consequences of what he knew. The first
close relationship with the debtor, such as certain relatives, partners, officers, directors, and those in control of the debtor. 0

If each of the foregoing elements of a preference is established, the bankruptcy trustee is entitled to invalidate the transfer under Section 547(b). It should be emphasized that each of these elements must be shown to exist at the time of the transfer, except the seventh element relating to the effect of the transfer, which is determined after the bankruptcy case is commenced.

An action by the bankruptcy trustee under Section 547 to set aside a preferential transfer must be commenced before the earlier of two years after his appointment or the time the bankruptcy case is closed or dismissed. If a debtor in possession is serving in a case under Chapter 11 of the Code, it appears that the two-year limitation period will not commence unless and until a bankruptcy trustee is appointed. Once the

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step is indeed a question of fact. A typical illustration is resolving a conflict in testimony, as when a bankrupt insists that he told the creditor he was being forced to close down and the creditor denies it; another is determining the creditor's knowledge by a factual inference, as when a bankrupt's poor financial condition has been bruited about in the trade, the creditor denies having heard of it, but his conduct, e.g., in pressing for more than usual security, suggests that he had.

Id. at 587-88.

Once having established what the creditor knew, a determination must be made whether the circumstances are such as would incite a man of ordinary prudence to make inquiry so that he is chargeable with notice of all facts which a diligent inquiry, not only of the debtor, but of others, would have disclosed. *See* Green v. Edwards & Sons, Inc., 17 COLLIER BANKR. CAS. 592 (8th Cir. 1978); *In re* Hygrade Envelope Corp., 366 F.2d 585 (2d Cir. 1966); Shaw v. United States Rubber Co., 361 F.2d 674 (5th Cir. 1966).


*See supra* note 36.


*See infra* notes 147-150, and accompanying text.


*See* 4 COLLIER ON BANKRUPTCY ¶546.02 at 546-6 (15th ed. 1981) [hereinafter "COLLIER"].
bankruptcy trustee avoids the preferential transfer under section 547, he is empowered by Section 550 of the Code to recover the property itself, or, if the court so orders, the value of the property. Such recovery is available against both the initial transferee of the debtor and the entity for whose benefit the transfer was made, as well as against any subsequent transferee of the property, unless the subsequent transferee took the property for value, in good faith and without knowledge of the voidability of the transfer avoided. However, the bankruptcy trustee is entitled only to a single satisfaction. An action under section 550 is barred if it is not commenced before the earlier of one year after the avoidance of the transfer and the time the case is closed or dismissed.

B. Preference Analysis in Company Bankruptcies

In the context of an IDB financing, the concern frequently is expressed that payments received by the bondholders on account of the IDBs they hold may be subject to recovery as preferences by the bankruptcy trustee if the company files for, or is placed into, bankruptcy. Whether this concern is well-

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68 11 U.S.C. § 550(a)(1) (Supp. III 1979). Section 550(a), which specifies the transferees from whom such recovery may be had, uses the disjunctive "or" when specifying them. Section 102(5) of the Code, however, makes clear that the word "or" is not exclusive. 11 U.S.C. § 102(5) (Supp. III 1979); See also 124 CONG. REC. H11097 (daily ed. Sept. 28, 1978); 129 CONG. REC. S17414 (daily ed. Oct. 6, 1978).
73 Regardless of whether it is insolvent in a balance sheet sense, the company may be placed into either a Chapter 7 liquidation case or a Chapter 11 reorganization case if it is shown that the company is "generally not paying [its] debts as such debts become due" or that within 120 days before the filing of the petition a custodian (other than one appointed or authorized to take charge of less than substantially all of its property to enforce a lien thereon) was appointed for the company or took possession of its assets. 11 U.S.C. § 303(b) & (h) (Supp. III 1979). The involuntary petition must be filed by at least three creditors of the company who hold claims that are not contingent as to liability and that in the aggregate exceed by at least $5,000 the value of any security held by them. 11 U.S.C. § 303(b)(1) (Supp. III 1979). If, however, the company has fewer than 12 creditors holding unsecured claims, a single qualified creditor whose unsecured claim equals at least $5,000 may commence the involuntary case. 11 U.S.C. § 303(b)(2) (Supp. III 1979).

As will be seen later in the text, an issuer may not be placed involuntarily into bankruptcy. See infra notes 107-21 and accompanying text.
founded will, of course, depend upon whether each of the previously discussed elements of a preference is shown to exist.

Putting aside for a moment the first two of the seven essential elements, it is relevant at the outset to ascertain whether the bondholders are "creditors" of the company so as to satisfy the third requirement that the transfer be "to or for the benefit of a creditor" of the debtor. Section 101(9) of the Code defines "creditor" to include any "entity that has a claim against the debtor that arose at the time of or before the order for relief concerning the debtor." Since one cannot be a creditor unless one holds a claim against the debtor, the Code's definition of a "claim" must be consulted. A "claim" is defined by section 101(4) of the Code to include a "right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured or unsecured." In situations where a party's only rights are against property of the debtor and not against the debtor personally, as is the case in nonrecourse loan agreements, section 102(2) of the Code makes clear that such a claim against property of the debtor is nonetheless to be regarded as a claim against the debtor.

77 11 U.S.C. § 102(2) (Supp. III 1979). If the property of the debtor securing the creditor's claim is worth less than the total amount of the claim, § 506(a) of the Code provides that the creditor has two claims: he is deemed to be the holder of a secured claim to the extent of the value of his collateral and the holder of an unsecured claim to the extent of the deficiency. 11 U.S.C. § 506(a) (Supp. III 1979). The unsecured portion of a nonrecourse claim would not be enforceable against the debtor in a Chapter 7 case. 11 U.S.C. § 502(b)(1) (Supp. III 1979). In a Chapter 11 reorganization case, however, § 1111(b)(1)(A) of the Code overrides the effect of § 502(b)(1) with respect to the undersecured, nonrecourse claim and provides that the unsecured portion of the claim is not unenforceable solely because it is without recourse to the debtor. The principal purpose of § 1111(b)(1)(A) is to prevent the undersecured, nonrecourse creditor from being deprived of his security in the Chapter 11 case by the debtor's payment to him of its appraised value, thereby leaving him with an unenforceable unsecured claim for the deficiency. Although the affected creditor may elect treatment of his claim different from that afforded by § 1111(b)(1)(A), a discussion of the circumstances making such different treatment advisable is beyond the scope of this article. For an insightful discussion of the subject, see Klee, All You Ever Wanted to Know About Cram Down Under the New Bankruptcy Code, 53 AM. BANKR. L.J. 133 (1979).
Applying the foregoing definitions to an IDB financing, it is probable that, notwithstanding the nonrecourse provisions of the typical IDB, the bondholders may be creditors of the issuer in situations where the issuer retains title to the project and executes a mortgage on the project to secure the IDBs. The bondholders, in such situations, have a claim against property of the issuer by virtue of the mortgage on the project to the bond trustee. However, the IDBs, which are the debt obligations of the issuer alone, themselves establish no debtor-creditor relationship between the company and the bondholders. Such a relationship between the company and the bondholders nevertheless does exist by virtue of the rights acquired through the issuer's assignment of the financing agreement to the bond trustee for the bondholders' benefit. Furthermore, if the company rather than the issuer is the owner of the project, the bond trustee as mortgagee of the project on behalf of the bondholders would have a claim against property of the company to insure payment of the IDBs. This claim against the project would qualify the bondholders as creditors of the company within the meaning of the Code.

Even though the bondholders are creditors of the company, they do not receive directly from the company any transfer of its property. Rather, the payments on their IDBs are received derivatively from the bond trustee. The third element of a preference, it will be recalled, may be satisfied either by a transfer directly from the debtor to the creditor or by a transfer to a third party for the creditor's benefit. Hence, the fact that the bondholders' receipt of payments from the company flows through an intermediary, the bond trustee, for ultimate disbursement to them will not prevent the payments from constituting a preference.

The question next arises whether the payment to the bond trustee for the bondholders' benefit constitutes a "transfer" within the meaning of section 547. The Code's definition of "transfer" is extremely broad. It includes "every mode, direct or indirect, absolute or conditional, voluntary or involuntary, of..."
disposing of or parting with property or with an interest in pro-

Based on this definition, it is readily apparent that the company's payments to the bond trustee would be a parting with property sufficient to create a transfer within the meaning of the provision.

Section 547, however, clarifies for preference purposes the time when a transfer is deemed to have been made. It provides that "a transfer is not made until the debtor has acquired rights in the property transferred." Once the debtor has acquired such rights, the time when the transfer is deemed to have been made will generally depend upon when it was perfected. If the transfer is perfected within 10 days after it first took effect between the parties, then the transfer is "made" when it took effect. If the transfer is perfected after the 10-day period, section 547 states that the transfer is not deemed to have been made until it is perfected. Moreover, if it is not perfected by the date of bankruptcy, the transfer is deemed to have been made immediately before the filing of the bankruptcy petition.

Since a determination of when a transfer is deemed to have been made will hinge upon when it is perfected, the concept of perfection is an important one. Section 547 provides that a transfer of personal property is perfected when under applicable nonbankruptcy law a "creditor on a simple contract cannot acquire a judicial lien that is superior to the interest of the

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See, e.g., In re Associated Gas & Elec. Co., 137 F.2d 607 (2d Cir. 1943); Schloss v. Powell, 93 F.2d 518 (4th Cir. 1938); Mercantile Trust Co. v. Schafly, 299 F. 202 (8th Cir. 1924).


11 U.S.C. § 547(e)(2)(A) (Supp. III 1979); see Seeley v. Church Bldg. & Interiors, Inc. (In re Church Bldg. & Interiors, Inc.), 14 Bankr. 128 (Bankr. W.D. Okla. 1981) (perfection of transfer occurred 87 days prior to bankruptcy, but by virtue of relation back, transfer was deemed to have been made outside 90 day period); Still v. Murfreesboro Prod. Credit Ass'n (In re Butler), 3 Bankr. 182 (Bankr. E.D. Tenn. 1980).


transferee." If under applicable nonbankruptcy law a creditor on a simple contract of the company could not obtain a judicial lien upon the funds in the bond trustee's possession that is superior to the bond trustee's interest therein, then the company's remittance of those funds to the bond trustee would immediately effect a transfer for section 547 preference purposes.

While it is beyond the scope of this article to analyze this question under the applicable laws of each jurisdiction, it is reasonable to conclude that such laws would rarely work to vest a creditor with a judicial lien on the funds superior to the fiduciary interests therein of the bond trustee. For the purpose of this article, therefore, it will be assumed that applicable nonbankruptcy law would generally dictate a result favorable to the transferee.

The term "simple contract" is derived from former § 60a(d) of the Bankruptcy Act. See S. Rep. No. 989, 95th Cong., 2d Sess. 89, reprinted in 1978 U.S. CODE CONG. & AD. NEWS 5787, 5875. A judicial lien creditor in some jurisdictions may levy execution upon money which is in the possession of the debtor or which is held by a third party for the debtor's benefit and identifiable as his money. See, e.g., Kyne v. Kyne, 16 Cal. 2d 436, 106 P.2d 620 (1940); Harvey v. Wright, 80 Ga. App. 232, 55 S.E.2d 835 (Ga. Ct. App. 1949); Sullivan v. Tinker, 140 Pa. 135, 21 A. 247 (1898). However, if the money is transferred by the debtor prior to the existence of the judicial lien and the transfer is not otherwise voidable under applicable nonbankruptcy law, then it is highly unlikely that the money in the hands of a third party under claim of right could be levied upon by a subsequent judgment creditor of the debtor. See 49 C.J.S. Judgments § 485(a) (1947); 46 AM. JUR. 2D Judgments §§ 245-89 (1969).
bond trustee in a contest between it and a judgment creditor on a simple contract of the company.

From the preceding discussion, it can be seen that the first and third elements of a preference may exist in an IDB financing. The second element, which requires that the transfer consist of "property of the debtor," is readily met if the funds used to make the payment to the bond trustee are, in fact, property of the company. If the issuer retains ownership of the project and if the funds used to make the payment consist solely of revenues derived from the operation of the project, a question may be raised as to whether the funds may rightly be considered to be property of the company. It is likely, however, that the courts would find the company to have had an interest in the revenues sufficient to qualify them as its property, rather than as property the company is administering merely as the issuer's agent. If, on the other hand, the company is the owner of the project and, consequently, the revenues derived from it, payments to the bond trustee out of those revenues would constitute transfers of its property that would meet the second element of a preference.

The fourth element of a preference is that the transfer must be "for or on account of an antecedent debt owed by the debtor before such transfer was made." The term "antecedent debt" does not mean that the debt must be past due. Rather, a debt is antecedent to a transfer if it existed prior to the time that the transfer was made. In an IDB transaction, the indebtedness of the company is evidenced by the financing agreement, which is executed concurrently with the issuance and sale of the IDBs and assigned by the issuer to the bond trustee. Even if that indebtedness is payable in installments, the payments on those installments as they mature nevertheless are made on account of a debt which was previously incurred to the bondholders. It is

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91 See Ledford v. Fort Hamilton Hughes Memorial Hosp. Center (In re Mobley), 15 Bankr. 573 (Bankr. S.D. Ohio 1981); See also Ross v. Francis, 72 F.2d 358 (2d Cir. 1934); Quinn v. Union Nat'l Bank, 32 F.2d 762 (6th Cir. 1929); In re Specialty Candy Co., 295 F. 508 (7th Cir. 1923).
therefore antecedent to the payments. Accordingly, the fourth element of a preference is present.

To establish the fifth element of a preference, the bankruptcy trustee must demonstrate that, at the time of the payment in question, the company was "insolvent" within the meaning of the Code. The term "insolvent" is defined by section 101(26) of the Code to mean that the financial condition of the debtor is such that the sum of his debts is greater than all of his property, at a fair valuation, exclusive of property transferred, concealed or removed with intent to hinder, delay or defraud his creditors. Although the Code does not provide any guidance as to the method by which a debtor's assets are to be valued, the assets of a business entity would presumably be valued as a going concern. If the company's sole asset is the project, as is sometimes the case when IDBs are used as the financing vehicle, there will likely be occasions during the construction of the project when, fairly valued, the project is worth less than the balance of the indebtedness under the financing agreement. Even after the completion of the project, its value may be less than such indebtedness as the result of poor maintenance and upkeep, uninsured damage to the project, mismanagement or market conditions that diminish its value. In either case, the company will be insolvent within the meaning of the Code. It should be emphasized that the company will be presumed insolvent under section 547 during the 90-day period preceding bankruptcy. If the company's insolvency and a payment by it to the bond trustee are

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44 See supra note 53.

44 See Edward R. Bacon Co. v. Grover, 420 F.2d 678 (9th Cir. 1970); In re Am. Kitchen Foods, 2 BANKR. CT. DEC. (CRR) 715 (D. Me. 1976); Utility Stationery Stores, Inc. v. American Portfolio (In re Utility Stationery Stores, Inc.), 12 Bankr. 170 (Bankr. N.D. Ill. 1981); 4 COLLIER at ¶547.27. If at the time of transfer the debtor is only nominally in existence as a business or is on its deathbed, then a going concern valuation of its assets on that date would be inappropriate. See In re Windor Indus., Inc., 18 COLLIER BANKR. CAS. 688 (N.D. Tex. 1978). See also COLLIER ¶ 101.26(1).

52 See supra note 54.
contemporaneous, the fifth element of a preference will be sustained.

The sixth element of a preference requires the bankruptcy trustee simply to prove that the repayment by the company was made on or within 90 days before the date of the filing of the petition. If, contrary to the assumption stated earlier, the bond trustee's interest in the payments received from the company is not superior under applicable nonbankruptcy law to a judicial lien thereafter obtained on a simple contract by a creditor of the company, then as previously discussed the transfer would be deemed to have been made immediately before the filing of the petition by the company rather than when it took effect between the parties. The undesirable result would be that even if a payment was made to the bond trustee outside of the 90-day preference period, the payment could be deemed to have been made within the 90-day period and therefore vulnerable to avoidance.

The seventh and final element of a preference relates to the effect of the transfer. If the payment by the company to the bond trustee, when added to the amount of payments to which the bondholders would be entitled on the balance of their claims in a Chapter 7 case, enabled the bondholders to receive more than they would have received in a Chapter 7 case without the pre-bankruptcy payments, then the payments will be adjudged preferential. Assume, for example, that within 90 days of its bankruptcy under Chapter 7 the company pays a total of $1,000,000 against an IDB indebtedness of $5,000,000, leaving a balance owed on the IDBs in bankruptcy of $4,000,000. Assume further that the obligations of the company to the bondholders are general unsecured claims and that the class of general unsecured claims will receive a payment against the company. The $1,000,000 pre-bankruptcy transfer, plus the $2,000,000 the bondholders would receive in a Chapter 7 case (50% of $4,000,000) result in the bondholders realizing a total of $3,000,000. However, if the pre-bankruptcy transfer had not been made, the bondholders total claims in the Chapter 7 case would amount to $5,000,000 and a 50% distribution to them in bankruptcy would yield a net return to them of $2,500,000, or $500,000 less than what they would receive if the pre-bankruptcy payment had not

been made. Accordingly, under the facts of this hypothetical, the seventh element of the preference would be satisfied and the pre-bankruptcy transfer to the bondholders would be subject to avoidance.\textsuperscript{98}

If each of the seven necessary elements of a preference is established, the bankruptcy trustee is empowered under section 547 to set aside the transfer of funds by the company to the bond trustee. Additionally, the bankruptcy trustee will be authorized under section 550 to recover the funds transferred by the company if they are in the hands of the bond trustee at the time of bankruptcy.\textsuperscript{99} Because section 550 sanctions recovery from both the initial transferee (the bond trustee) or the entity "for whose benefit such transfer was made" (the bondholders),\textsuperscript{100} the bankruptcy trustee could institute a recovery action against the bondholders themselves.\textsuperscript{101} Section 550, it should be added, permits the bankruptcy trustee with court approval to recover the value of the property in lieu of the property itself,\textsuperscript{102} not only

\textsuperscript{98} If each of the first 6 elements of a preference is established, then the seventh element will almost assuredly be satisfied where the bankruptcy distribution to holders of unsecured claims is less than 100%. \textit{See} Palmer Clay Prod. Co. v. Brown, 297 U.S. 227 (1936).


\textsuperscript{101} An interesting question is whether the bankruptcy trustee might also be entitled under § 550(a) to recover the value of a preferential transfer from the issuer as an entity "for whose benefit the transfer was made." It might be asserted that the company's payments to satisfy its obligations under the financing agreement serve to "benefit" the issuer by reducing the issuer's indebtedness to the bondholders under the IDBs. While many issuers such as municipalities and counties are governmental units that enjoy sovereign immunity, some bankruptcy courts have seized upon the limited waiver of sovereign immunity set forth in § 106 of the Code to justify the prosecution of avoidance actions against governmental units. \textit{See}, e.g., Remke, Inc. v. United States (\textit{In re} Remke, Inc.) 5 Bankr. 24 (Bankr. E.D. Mich 1980).

Notwithstanding the superficial appeal of the above reasoning, recovery against issuers of IDBs should be denied under § 550(a). In a real sense, the company's payments do not benefit the issuer, inasmuch as the IDBs are nonrecourse obligations of the issuer. The issuer cannot be said to benefit from a reduction in the balance owed on the debt which by contract cannot be collected from it in any event.

from the person for whose benefit the initial transfer was made but also from the initial transferee, who may no longer possess the property. As a later section of this article points out, this may pose significant problems for the bond trustee who, having disbursed the funds to the bondholders, no longer possesses the funds sought to be recovered.

C. Preference Analysis in Issuer Bankruptcies

The preceding section of this article examined the potential for preference recovery in a bankruptcy case involving the company. It is, of course, possible that the issuer rather than the company will be the subject of a bankruptcy case. However, for the reasons given below, it is submitted that the preference concerns of bondholders in an issuer bankruptcy are less significant than in the case of a company bankruptcy.

Issuers of IDBs, which would include municipal corporations, counties, and industrial development authorities, do not qualify for relief under either the liquidation provisions of Chapter 7 or the reorganization provisions of Chapter 11. Rather, they are eligible for relief only under Chapter 9 of the Code, which governs debt adjustments of a municipality. The term "municipality," it should be noted, means a political subdivision, public agency, or instrumentality of a state. Most, if not all, issuers would fit within this definition. A municipality may not commence a Chapter 9 case unless the laws of its state authorize it to be a debtor under Chapter 9. To date, there are only 16 states that specifically authorize their political subdivisions to file for such relief. The issuer in a Chapter 9 case possesses the

103 See infra notes 126-27 and accompanying text.
104 Section 109(a) and (d) of the Code make clear that only "persons" are eligible for relief under Chapters 7 and 11. The word "person" is defined by § 101(30) to include only individuals, partnerships and corporations and to exclude governmental units. Included within the definition of a "government unit" is a municipality, which, as the text of the article indicates, comprises most issuers of IDBs. See 11 U.S.C. § 101(21) (Supp. III 1979).
108 See Dixon & Manthe, Municipal Adjustments in 1981 ANN. SURV. BANKR. L. 141, 145 (1981). The 16 states with statutes currently authorizing a municipality to file for relief under the bankruptcy Code are Arizona, Arkansas, California,
same power as a trustee in an ordinary bankruptcy case to set aside preferences. If the issuer should for any reason decline to exercise its avoidance powers, the court at the request of a creditor may appoint a trustee for that purpose.

A threshold question in the preference analysis of an issuer bankruptcy is whether the holders of IDBs can be properly considered as creditors of the issuer. A creditor within the meaning of the Code, it will be recalled, is the holder of a claim against the debtor. A claim exists when there is a right to payment from the debtor or when there is a claim against property of the debtor. Because the IDBs are nonrecourse obligations of the issuer, the bondholders do not have any right to payment from the issuer. Their sole right to payment is from the company. This right arises under the financing agreement which the issuer has assigned to them. Moreover, if the IDB financing is structured so that the project is titled in the company, then the bondholders who are granted a mortgage on the project have no

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In PennBank v. The Hon. William B. Washabaugh, Jr., 5 COLLIER BANKR. CAS. 2d 869 (3d Cir. 1981), a secured creditor and the State of Pennsylvania moved to dismiss a Chapter 9 petition filed by a municipal authority that was incorporated under the Pennsylvania Municipal Authorities Act to construct and operate a sewer system. The movants contended that the bankruptcy court lacked jurisdiction because the Authority had not received permission from the state to file for such relief as demanded of political subdivisions under PA. STAT. ANN. tit. 53, §§ 5571-5572 (Purdon 1972). The bankruptcy court ruled that the Authority was not required to obtain permission from the state because Pennsylvania law excluded it from the definition of "political subdivision." The secured creditor thereupon filed with the United States Court of Appeals for the Third Circuit a petition for writs of mandamus and prohibition seeking to prevent the bankruptcy court from assuming jurisdiction. Without commenting upon the merits of the case, the Court of Appeals denied the petition because it felt that the issue of jurisdiction should be raised through the prescribed process of appeal.

Section 901(a) of the Code makes the preference provisions of § 547 applicable in municipal adjustments. Section 902(4) specifies that the term "trustee" when used in § 547 shall be understood to mean the debtor in a municipal adjustment case.

10 Section 901(a) of the Code makes the preference provisions of § 547 applicable in municipal adjustments. Section 902(4) specifies that the term "trustee" when used in § 547 shall be understood to mean the debtor in a municipal adjustment case.


12 See supra note 50 and accompanying text.

13 See supra notes 74-77 and accompanying text.
claim against any property of the issuer. Because the issuer's interest in the financing agreement is assigned to the bondholders, the financing agreement is no longer the issuer's property against which the bondholders have a claim. It would appear, therefore, that the bondholders have no claim against the issuer, and cannot be creditors of the issuer for section 547 purposes, with the possible exception involving situations in which the issuer retains title to the project.

The foregoing interpretation is borne out by the legislative history of the Code, which indicates that:

In a case under chapter 9 . . . "claim" does not include a right to payment under an industrial development bond issued by a municipality as a matter of convenience to a third party. . . . The bonds are sold on the basis of the credit of the company on whose behalf they are issued, and the principal, interest, and premium, if any, are payable solely from payments made by the company to the trustee under the bond indenture and do not constitute claims on the tax revenues or other funds of the issuing municipalities. The municipality merely acts as a vehicle to enable the bonds to be issued on a tax-exempt basis."

If this legislative history is taken literally, the holders of IDBs can never be subjected to a successful preference attack in an issuer bankruptcy because they are not creditors of the issuer.

Even assuming that the bondholders could be deemed creditors of the issuer in situations where the issuer retains title to the project, it is by no means clear that payments by the company to the bond trustee would constitute a transfer of property of the issuer. For example, if debt service on the IDBs is paid by the company out of funds separate and apart from that which it derives from the project, then no property of the issuer is transferred to the bondholders. While it might be urged that those payments are property to which the issuer is entitled under the financing agreement, the issuer has assigned away its rights under that agreement to the bond trustee for the bondholders' benefit."


114 An analogous situation was present in the case of Diversified World Inv., Ltd. v. Omni Int'l, Ltd. (In re Diversified World Inv., Ltd.), 12 Bankr. 517 (Bankr. 1979).
If, on the other hand, the company uses project revenues to pay debt service on the IDBs, the question of whose property is

S.D. Tex. 1981). There the debtor purchased an airplane on an installment sale basis and leased the airplane to a third party. To further secure payment of the purchase price, the debtor assigned to the seller all rental payments due to it from the third party. After the debtor commenced a case under Chapter 11, it brought an adversary proceeding as debtor in possession to recover from its seller the sum of $537,340 in payments received by the seller from the lessee within 90 days of bankruptcy. The seller moved to dismiss the proceeding on two grounds: first, because the assignment of rentals, which took place outside the 90-day preference period, was complete when made; and second, because the payments received by it during the 90-day period were not transfers within the meaning of § 547(e). The court rejected the seller's argument and ruled that payments made to the seller as assignee of rentals that the debtor otherwise would have received were avoidable transfers under § 547. The court reasoned that the rental payments to the seller were "indirect transfers made for the benefit of" the debtor in that they were "intended to reduce" the debtor's obligations to the seller. Moreover, the court concluded that the debtor did not acquire any right to the rentals until they became due from the lessee. Because a transfer does not occur within the meaning of § 547(e) until the debtor had acquired rights in the property transferred, the court held that the transfer of the debtor's property took place as the rents accrued under the lease and not when the future rights to those rental payments were originally assigned. Id. at 519.

If one were to adopt the rationale of the court in Diversified World, then payments made by the company under a financing agreement that has been assigned to the bond trustee by the issuer to secure the IDBs would entail transfers of property of the issuer, and would satisfy the second element of a preference. It is submitted, however, that the court's reasoning in the Diversified World decision was based on a misconstruction of § 547(e). The debtor's right to receive rent under the lease constituted property of the debtor. The assignment of that right effectuated a transfer to the seller of all matured and unmatured rents under the lease. The seller in Diversified World, therefore, correctly asserted that the assignment by the debtor was a complete transfer of its property rights when it was made. The factual situation is no different from a pledge by a debtor of an installment note to secure his debt to the pledgee. The pledge itself is a transfer of the debtor's property and that transfer carries with it the right to receive the future installment payments upon the debtor's default.

Even if one were to accept the court's logic in Diversified World that the debtor had no rights in the rental payments until they matured, the court's result is not dictated by that logic. The rental payments represented nothing more than proceeds of a "receivable" (the right to payments under the lease), within the meaning of § 547(a)(3), to which the seller's lien by assignment attached. As provided in § 547(c)(5) of the Code, a transfer of a perfected security interest in a receivable or its proceeds is not subject to avoidance except to the extent that the creditor's claim on the ninetieth day before bankruptcy was not fully secured and the aggregate of all such transfers during the 90-day period caused a reduction in the creditor's collateral deficiency to the prejudice of unsecured creditors. The payment to the seller of the rentals did not operate to reduce any collateral
being transferred becomes a closer one. While the issuer may have legal title to the project itself, it does not necessarily follow that the issuer's interest extends to the income stream generated from the company's operation of the project. In all events, the issuer's legal interest, if any, does not give it an equitable interest in the project revenues, which pursuant to the financing agreement and other IDB documentation are dedicated exclusively to repayment of the debt under the financing agreement and ultimately to payment of the IDBs. Because use of the project revenues to pay the bondholders does not deplete the issuer's estate of funds to which it has any equitable interest, it cannot be said that the bondholders have been preferred over other creditors of the issuer. In sum, by assigning to the bond trustee its right to payment under the financing agreement, the issuer has effectively divested itself of any equitable interest in the project revenues.

From a purely technical point of view, the payments by the company to the bond trustee are not made on account of an antecedent deficiency by virtue of any increase in the value of the lease. On the contrary, payments on a lease for a fixed term diminish the value of the lease, and, in the Diversified World case, neither improved nor worsened the collateral position of the seller. Thus, the rental payments within 90 days of bankruptcy would be immune from avoidance under the exception afforded by § 547(c)(5) of the Code.

Although not expressly made an element of a preference under § 547, a number of pre-Code cases have held that the transfer must result in some depletion of the debtor's estate before there can be a preference. See Continental & Commercial Trust & Sav. Bank v. Chicago T. & Savings Co., 229 U.S. 435 (1913); In re Windor Indus. Inc., 18 COLLIER BANKR. CAS. 688 (N.D. Tex. 1978).

It should be noted that in situations where the issuer assigns its rights and interests under the financing agreement and the mortgage on the project to the bond trustee, the assignment would effect a transfer of property of the issuer. See Feilbach Co. v. Russell, 233 F.2d 412 (6th Cir. 1966). If each of the remaining elements of a preference could be established, the issuer's bankruptcy within 90 days of the assignment arguably could result in a § 547 avoidance. However, the assignment could qualify under § 547(c)(1) as an exception to the general preference rules. This exception exempts from preference attack a transfer that was intended by the debtor (issuer) and creditor to or for whose benefit the transfer was made (bondholders) to be a "contemporaneous exchange for new value" given to the debtor, but only if the transfer was in fact a substantially contemporaneous exchange. 11 U.S.C. § 547(c)(1) (Supp. III 1979).

Such an assignment, however, would not constitute a preference in the event of the company's bankruptcy because the net effect, the substitution of one creditor (the bondholders) for another (the issuer), does not result in any depletion of the company's estate. See Grubb v. General Contract Purchase Corp., 94 F.2d 70 (2d Cir. 1938); In re Loring, 30 F. Supp. 758 (D. Mass. 1939).
cedent debt owed by the issuer to the bondholders. The company's payments to the bondholders are, strictly speaking, in satisfaction of the debt of the company under the financing agreement. Admittedly these payments are in precisely the amount of the debt service on the IDBs and are applied directly to offset the IDB obligations. But it is at least arguable that the fourth element is not satisfied by payments from the company to the bond trustee to discharge the company's obligations under the financing agreement.

As a practical matter it will be an exceedingly difficult task for the issuer in a preference action to prove the preferential effect of the transfers to the bond trustee. To do so, the issuer must demonstrate what its creditors generally, and the bondholders in particular, would receive in a Chapter 7 liquidation case. Establishing the liquidation value of the assets of a political subdivision will be both time consuming and extremely expensive, and in many instances the issuer and its other creditors may conclude that the costs are simply not worth the contest. Moreover, the question of how much the issuer's creditors would receive in a Chapter 7 case would necessarily be based upon a theoretical valuation of its assets because a municipality is not eligible for Chapter 7 relief, and its assets may not be involuntarily liquidated.

Apart from the legal and practical difficulties of sustaining a preference action against the holders of IDBs, the threat of an issuer bankruptcy in the first instance is significantly less than the threat of a company bankruptcy. Unlike most non-public entities and individuals, municipalities may not be placed involun-

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117 An IDB financing is structured in many respects like a common law novation. A novation is effected by the substitution of a new debtor in the place of the old one, with the intent to release the latter and with the assent of all parties to the substitution. See generally 58 Am. Jur. 2d Novation § 1 (1971). For example, A (the company) owes B (the issuer) the same amount that B owes C (the bondholders), and B at the request of C orders A to pay that sum to C. Unlike a novation, however, the participants in an IDB financing do not intend that the obligations under the IDBs will be extinguished.


119 See supra note 104 and accompanying text.

and may not voluntarily seek bankruptcy protections unless certain conditions are satisfied, including proof that the municipality is insolvent or unable to meet its debts as they mature and is not seeking simply to evade its creditors or to obtain a moratorium on its debt service obligations. Moreover, issuers in many IDB financings are industrial development authorities, created by statute for the purpose of stimulating economic development through the issuance of non-recourse debt obligations that qualify for tax-exempt treatment. Because of the nonrecourse nature of the debt obligations they are allowed to incur, there is no incentive for them to seek an adjustment of their debts under Chapter 9 of the Code. Nor is there any incentive on their part to use Chapter 9 as a means to stave off foreclosure on a project which, though sometimes titled in the issuer, is in reality beneficially owned by the company and therefore primarily the company's economic concern. Where the issuer is a municipal corporation, county, or other political subdivision having recourse debt obligations that it may have an incentive to adjust, the political consequences of bankruptcy as well as the legal requirements for Chapter 9 eligibility provide in many cases a countervailing disincentive to the bankruptcy alternative.

In summary, the likelihood of a successful preference attack on bondholders in an issuer bankruptcy are, for both legal and


Section 303(b) of the Code makes provision for involuntary bankruptcy cases only under Chapter 7 and Chapter 11 of the Code. Moreover, § 901(a) of the Code makes applicable to Chapter 9 cases the provisions of § 301 of the Code, which authorizes voluntary bankruptcy cases, but does not incorporate the provisions of § 303 relating to involuntary cases.

The filing of an involuntary petition by a creditor of a municipality would constitute an impermissible interference with the governmental affairs of the political subdivision involved. See United States v. Bekins, 304 U.S. 27, 49-50 (1938). See generally, 4 COLLIER, at ¶ 900.02 & ¶ 900.03 (1981).


11 U.S.C. § 109(c)(3) (Supp. III 1979). For a pre-Code case in which an irrigation district was found to be solvent in a balance sheet sense, but unable to meet its maturing obligations on a cash basis, see Fano v. Newport Heights Irr. Dist., 114 F.2d 563 (9th Cir. 1940).

These conditions, while not expressly set forth in the Code, are implicit in the requirement contained in § 921(c) that the petition filed by the municipality he dismissed if, upon the objection of a creditor, it is found not to have been filed in good faith. See 4 COLLIER at ¶ 900.03 at 900-16 (15th ed. 1981).

See supra note 20 and accompanying text.
practical reasons, remote. Investors in IDBs should, therefore, focus their concerns on the credit standing of the company and the adverse consequences to them in the event of a company bankruptcy.

D. Preference Concerns of Bond Trustees and Guarantors

It will be recalled that section 550 enables the bankruptcy trustee to recover the property transferred or, if the court orders, the value of the property, either from the persons for whose benefit the transfer was made (the bondholders), from the initial transferee (the bond trustee), or both. Hence, even though the bond trustee no longer is in possession of the funds that were the subject of the bankruptcy trustee's avoidance action under section 547, the bond trustee would, under a literal reading of section 550, remain liable for the value of the transferred funds if the court authorized the bankruptcy trustee to recover such value in lieu of the property itself. It is submitted that the court should not sanction recovery from the bond trustee of the value of the payments disbursed by it as a fiduciary to the bondholders since the bond trustee is clearly an innocent intermediary. As noted by one commentator: "In such circumstances, the bankruptcy court should exercise its discretion to use its equitable powers under section 105(a) and 28 U.S.C. § 1481 to prevent an inequitable result." 127

Similarly, guarantors have rather unique preference concerns of their own in an IDB financing. First, guarantors must be ever mindful of the possibility of a preference recovery by the bankruptcy trustee from the bond trustee or the bondholders. Such a recovery will have the effect of increasing the extent of the guarantor's exposure under the guaranty agreement. Even if the IDBs are paid in full prior to bankruptcy and the guarantor's contingent liability to the bondholders extinguished, a later recovery of a preferential payment from the bondholders will likely operate to revive the guarantor's liability to them. 128

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126 See supra notes 67-70 and accompanying text.
128 See, e.g., Herman Cantor Corp. v. Central Fidelity Bank (In re Herman Cantor Corp.), 15 Bankr. 747, 750 (Bankr. E.D. Va. 1981) (noting that "although a surety is usually discharged by payment of the debt, he continues to be liable if
Second, it should be emphasized that section 547 makes possible the avoidance of transfers that are "for the benefit" of a creditor of the debtor.\textsuperscript{129} A guarantor, at the time of each payment by the debtor holds a contingent claim for reimbursement from the debtor in the event the guarantor is called upon to satisfy the debtor's obligations to the creditor.\textsuperscript{130} The guarantor's claim, though contingent, is a "claim" within the broad meaning of the Code\textsuperscript{131} and the guarantor is therefore a creditor of the debtor. Transfers by the debtor in payment of the creditor's claim operate to benefit the guarantor inasmuch as they reduce his exposure under the guaranty agreement with the creditor.\textsuperscript{132} If the transfer is avoided under section 547, then section 550, which authorizes the bankruptcy trustee to recover the property transferred or with court approval its value from the person "for whose benefit such transfer was made,"\textsuperscript{133} would apparently permit recovery of the value of the transfer from the guarantor.\textsuperscript{134} Case law under the preference provisions of both

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\textsuperscript{130} Kapela v. Newman, 649 F.2d 887 (1st Cir. 1981). Prudence dictates that a formal, written contract of reimbursement be executed between the guarantor and the debtor so that the scope of the debtor's reimbursement obligation can be specifically defined. However, even in the absence of an express agreement, an implied right of reimbursement or indemnity arises from the relationship. See, e.g., Fidelity & Deposit of Maryland v. Hobbs, 144 F.2d 5 (10th Cir. 1944); Howell v. Commissioner, 69 F.2d 447 (8th Cir. 1934); McConnell v. Scott, 15 Ohio 401 (1846). See generally RESTATEMENT OF SECURITY § 104(2) (1941); 38 AM. JUR. 2D Guaranty § 127 (1968).

\textsuperscript{131} The Code's definition of "claim" includes an right to payment, whether or not such right is contingent. 11 U.S.C. § 101(4) (Supp. III 1979). A contingent claimant, however, is not a "creditor" unless its claim against the debtor "arose at the time of or before the order for relief concerning the debtor." 11 U.S.C. § 101(9)(A) (Supp. III 1979). A guarantor's contingent claim arises at the time the assured creditor extends to the debtor credit that the guarantor is bound to pay if the debtor does not. Moreover, § 502(e)(2) of the Code makes clear that a reimbursement claim which becomes fixed after the commencement of the case is treated as if it had become fixed before the filing of the petition.


the Code and the former Bankruptcy Act appear to give support to this interpretation. Thus, in an IDB financing, if a transfer is set aside under section 547, the bankruptcy trustee may well seek recovery under section 550 from the guarantor.

There is one further area of concern for guarantors in an IDB financing. If, as is often the case, the company is a wholly-owned subsidiary of the guarantor, the guarantor may be adjudged to be a "person in control of the debtor" or an "affiliate" of the debtor and, therefore, an "insider" of the debtor. It will be recalled from the previous discussion in the text that, with respect to an insider creditor, the 90-day reach-back period for a preference is extended to include the period between 90 days and one year before the date of the filing of the bankruptcy petition. Thus, if in an IDB financing a payment by the company outside of the 90-day preference period applicable

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132 Id.

135 See, e.g., Cooper Petroleum Co. v. Hart, 379 F.2d 777 (5th Cir. 1967); Fenold v. Green, 175 F.2d 247 (2d Cir. 1949); In re Schleicher Printing Corp., 62 F.2d 503 (2d Cir. 1933); Walker v. Wilkinson, 3 F.2d 867 (5th Cir.), cert. denied, 268 U.S. 701 (1925); Swarts v. Siegel, 117 F. 13 (8th Cir.), appeal dismissed, 187 U.S. 638 (1902); Kobusch v. Hand, 156 F. 660 (8th Cir. 1907), cert. denied, 209 U.S. 547 (1908); Pennington v. Less, 183 F. Supp. 884 (S.D. Ala. 1959); Irving Trust Co. v. Manufacturers' Trust Co., 8 F. Supp. 686 (S.D.N.Y. 1934); Stern v. Paper, 183 F. 228 (D.N.D. 1910), aff'd, 198 F. 642 (8th Cir. 1912).

137 As pointed out earlier in the text, supra note 33 and accompanying text, the guarantor's undertaking may entail a guaranty of payment of either the IDBs themselves or the obligations under the financing agreement, or in some cases both. If payment of the IDBs alone is guaranteed, then strictly speaking the guarantor has no contingent claim against, and therefore is not a creditor with respect to, the company, unless the guaranty agreement otherwise gives the guarantor a right of recourse against the company. Absent such a right of recourse, any payments by the company should not be considered to be "for the benefit of" a creditor of the company because the guarantor, although benefited by the payments, has no claim against the company.


139 The term "affiliate" is defined by § 101(2) to include: "[A]n entity that directly or indirectly owns, controls, or holds with power to vote, 20 percent or more of the outstanding voting securities of the debtor. . . ." 11 U.S.C. § 101(2) (Supp. III 1979). An "affiliate," as defined above, is an insider of the debtor. 11 U.S.C. § 101(25)(E) (Supp. III 1979).


141 See supra note 58 and accompanying text.

to the bond trustee and bondholders preferentially benefits an insider guarantor, the bankruptcy trustee may be barred from avoiding and recovering the transfer as against both the bond trustee and the bondholders, but may have a sustainable cause of action against the guarantor. 143

In light of the preference risks to which they may be subject, bond trustees and guarantors of IDB issues should take steps to maximize their protection against such occurrences.

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The case of In re Schleicher Printing Corp., 62 F.2d 503 (2d Cir. 1933) is illustrative of a situation in which a guarantor may be subject to preference attack while the actual transferee is not. In Schleicher, the 50% owner and president of the corporate debtor guaranteed the debtor's note for $2,000 to a bank. The note was also secured by a first mortgage in favor of the bank on the debtor's property. Approximately 30 days before its bankruptcy, the corporation paid $1,827 to the bank. The court found that the payment benefitted the guarantor by reducing his exposure under the guaranty and was therefore preferential as to him. However, the court ruled that the payment did not result in a preference to the bank, because the bank did not have reasonable cause to believe that the debtor was insolvent (as required by the predecessor section to § 547).

The court's decision in Schleicher is consistent with the result that would have been reached on similar facts under § 547. Although the bank in that case escaped preference attack because of its lack of reasonable cause to believe insolvency, that element of a preference has been deleted under § 547 except in situations involving an insider transferee. However, assuming that the $2,000 note of the bank was fully secured by the mortgage on the debtor's property, the bank could have successfully defended a preference action under the Code. See infra note 145 and accompanying text. Furthermore, if the payment to the bank had been made more than 90 days, but less than one year, prior to the bankruptcy, the 90-day rule would bar recovery from the bank. The guarantor, however, as an insider of the debtor, would nonetheless be accountable for the transfer. See Seeley v. Church Bldg. & Interiors, Inc. (In re Church Bldg. & Interiors), 14 Bankr. 128 Ed. 74 (Bankr. W.D. Okla. 1981). One commentator has concluded that, even if a transfer is voidable under § 547 only as against an insider guarantor who benefited from it, the property transferred or its value may be recovered under § 550 not only from the guarantor but also from the transferee creditor. Pitts, Insider Guaranties and the Law of Preferences, 55 AM. BANKR. L. J. 343 (1981). Other authorities, while conceding that a literal reading of § 550 might permit such a result, have concluded that recovery should be restricted to the insider guarantor. 4 COLLIER ¶ 550.02 at 550-7 (15th ed. 1981); accord, Seeley v. Church Bldg. & Interiors, Inc. (In re Church Bldg. & Interiors), 14 Bankr. 128 (Bankr. W.D. Okla. 1981). Otherwise, these authorities observe, a creditor who does not insist upon a third-party guaranty might be better off than he would be with one. In the view of the authors of this article, Congress did not intent to sanction recovery under § 550 from persons who did not within the meaning of § 547 preferentially receive or benefit from the transfer.
Bond trustees, for example, should insist upon provisions in the indenture that give to them a first lien upon all security for the IDBs, including all revenues from the project and payments received by them for the bondholders, to indemnify them against any losses sustained in their fiduciary capacities. Guarantors should require provisions in the guaranty agreement giving to them subrogation rights to all security for the IDBs to the extent that they are called upon either to satisfy the bondholders' claims against the company or to absorb any losses resulting from preference claims of the bankruptcy trustee. Alternatively, a guarantor might, in an appropriate case, consider releasing the company from any claim of reimbursement that might result from payments that the guarantor is called upon to make under the guaranty. By releasing its reimbursement rights, the guarantor might foreclose the argument that it has a claim against the company and that it is thereby a creditor of the company.

E. Fully and Partially Secured IDB Issues

As a general rule in IDB financings, the project stands as collateral security for the payment of the IDBs. If the IDB financing is structured so that the issuer is the owner of the project, the issuer will normally grant a mortgage or security interest in favor of the bond trustee to secure the IDBs. If the company holds title to the project, the company will either mortgage the project to the issuer to secure the financing agreement, which the issuer in turn assigns to the bond trustee, or mortgage the project directly to the bond trustee to secure the financing agreement or the IDBs themselves. The net effect, in any event, is that the bondholders through the bond trustee have recourse against the project in the event of a default in payment of the IDBs.

As observed earlier in this article, a transfer is not voidable under section 547 unless it has a preferential effect. In the case of a transfer to the holder of an unsecured claim, the effect of the transfer is determined by first adding the value of the transfer to the distribution that the creditor would receive on the balance of his claim in a Chapter 7 case, and by then comparing the resulting figure with what the distribution to the creditor would have been on the full amount of his claim had the pre-

144 See supra note 97 accompanying text.
bankruptcy transfer not been made. If the net effect is that the transfer enabled the creditor to enhance his position over what it would have been without the transfer, then as previously noted the seventh element of a preference is present.

In the case of a transfer to the holder of a fully secured claim, a different result may be dictated. If the value of the debtor's property equals or exceeds the creditor's claim, then a payment on account of the fully secured claim would not enable the creditor to receive more than he would receive in a Chapter 7 case had the pre-bankruptcy payment not been made. The payment would therefore not be preferential.\(^5\) This result follows because in a Chapter 7 case, the fully secured creditor's claim would be satisfied in full from this collateral with or without the pre-bankruptcy payment.\(^4\) A question that is not clearly resolv-

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\(^4\) The effect of a transfer to a fully secured creditor is no different in situations where a person other than the debtor, such as a guarantor, collateralizes the creditor's claim. Accordingly, it should be inconsequential, as far as the seventh element of a preference is concerned, whether the issuer or the company is the owner of the project that secures payment of the IDBs.

In the case of Herman Cantor Corp. v. Central Fidelity Bank (In re Herman Cantor Corp.), 15 Bankr. 747 (Bankr. E.D. Va. 1981), however, the bankruptcy court ruled that a creditor whose claim was fully secured by property of a guarantor could be required to disgorge payments received from the debtor within 90 days of bankruptcy. The court reasoned that the seventh element of a preference was satisfied because the debtor's payments benefitted the guarantor by reducing her exposure under the guaranty and enabled her to receive (or retain) more than she would have received (or retained) if the case were a Chapter 7 case and the payments had not been made. It is submitted that the court was correct in determining that a preference existed, but incorrectly concluded that the preferential transfer was recoverable from the creditor. For the reasons discussed earlier in the text, see supra notes 128-43 and accompanying text, the guarantor in Her-
ed by section 547, however, and one not yet squarely addressed by the courts, is the date as of which a valuation of the creditor's collateral, and therefore the net effect of the transfer, is to be made. An answer to this question is essential in those cases in which the value of the collateral fluctuates. If the collateral value is at all times greater than the amount of debt it secures, then of course the question of the proper date for valuation is of academic interest only.

To illustrate, assume that the project securing the IDBs is worth $1,000,000 on the date that the company makes a payment of $100,000 and that the total IDB indebtedness on that date is $900,000. On the transfer date, the bondholders' claims are fully secured and, if the project were then liquidated in a Chapter 7 case, their claims would be satisfied in full regardless of whether or not the $100,000 payment had been made. Hence, using the transfer date as the date of valuation, no preference would result. Assume further that a bankruptcy petition is filed on the ninetieth day following the transfer and the value of the project has declined to $800,000. With the aid of the pre-bankruptcy transfer, the balance of the bondholders' claims would be retired from a liquidation of the project notwithstanding its decline in value: $900,000 - [$800,000 + $100,000] = 0. If the pre-bankruptcy transfer had not been made, the bondholders would have realized a deficiency from a liquidation of the project in precisely the amount of the transfer: ($900,000 - $800,000 = $100,000). Using the date of bankruptcy as the date of valuation, it can be seen that the pre-bankruptcy payment enabled the bondholders to receive more than they otherwise would have received. Finally, assume that the bankruptcy trustee files a section 547 action against the bondholders some 120 days after bankruptcy and the value of the project has increased in value to $950,000. If then liquidated, the project would net to the bondholders a sum sufficient to satisfy the full amount of their claims without the benefit of the pre-bankruptcy transfer. It is apparent, therefore, that the date selected by the court to test the value of the collateral securing a claim can be critical to the outcome of the preference action.

Some guidance on this question can be found in Palmer Clay Products Co. v. Brown, a case arising under the predecessor

\[\text{man Cantor was the only party to receive a preference.}\]

\[\text{197 U.S. 227 (1936).}\]
preference section to section 547. Concluding that the effect of the transfer is not to be determined as of the date of transfer, the Supreme Court in *Palmer* stated:

Whether a creditor has received a preference is to be determined, not by what the situation would have been if the debtor's assets had been liquidated and distributed among his creditors at the time the alleged preferential payment was made, but by the actual effect of the payment as determined when bankruptcy results. . . . We may not assume that Congress intended to disregard the actual result, and to introduce the impractical rule of requiring the determination, as of the date of each payment, of the hypothetical question: What would have been the financial result if the assets had then been liquidated and the proceeds distributed among the then creditors.148

While the *Palmer* case does clarify when the effect of the transfer is *not* to be determined in the case of transfers to unsecured creditors,149 it does not resolve precisely when it is to be determined, particularly in the case of transfers to creditors holding secured claims.150 In cases decided thus far under the

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148 *Id.* at 229.

149 Some respected commentators have read the *Palmer* case to mean that the effect of the transfer is to be determined as of the date of the commencement of the bankruptcy case. See, e.g., P. Murphy, *Creditors' Rights in Bankruptcy* § 10.12 (1981). While the Court in *Palmer* may have intended the date of bankruptcy to be the proper determination date, it indicated that the "actual effect" of the transfer "when bankruptcy results" is controlling, 297 U.S. at 229, which might imply that the determination is to be made at the time the issue arises in the context of a preference action, when the actual result of the transfer can more precisely be measured. See Belfance v. BancOhio Nat'l Bank (In re Gastaldo), 13 Bankr. 808 (Bankr. N.D. Ohio 1981). Moreover, the *Palmer* case does not foreclose the argument that the effect of a transfer to the holder of a secured claim should be measured by testing the value of the security on the transfer date. See infra note 154.

150 The court in Baranow v. Gibraltar Factors Corp. (In re Hygrade Envelope Corp.), 393 F.2d 60 (2d Cir. 1968) was confronted with a situation in which the value of the collateral transferred to the creditor significantly increased by the time of the debtor's bankruptcy. The creditor in *Hygrade* took an assignment from its insolvent corporate debtor of a "key man" term insurance policy in the face amount of $100,000 on the life of the debtor's general manager to secure a pre-existing debt of some $300,000. At the time of the assignment, the surrender value of the policy was $393. Nine days after the assignment, the general manager died and the creditor received a payment under the policy of $101,000. Shortly thereafter the debtor was placed involuntarily into bankruptcy. Its trustee sought to recover from the creditor the value of the insurance policy, which the trustee asserted was equal in amount to the proceeds received thereunder by the creditor. The creditor argued, and the lower court agreed, that
Code, the courts have not as yet squarely addressed the question. Some courts have appeared to determine the effect of the transfer by adopting the valuations given to the creditor's collateral in the debtor's schedule of assets, which sometimes reflect value on the date the schedule is prepared. Other courts appear to have used the value of the collateral on the date of the filing of the petition as the proper date for testing value. Still others have used the most current valuation of the collateral during the bankruptcy case. In none of these cases did the court consider whether the value of the collateral on the date selected was equal to, greater than, or less than its value on the transfer date. Although the proper date of valuation remains

the extent of the preference, if any, was the value of the policy at the time of its transfer, or $393. Reversing the lower court on this point, the United States Court of Appeals for the Second Circuit ruled that the effect of the transfer, and therefore, the value of the policy as collateral, was to be determined not on the date that the transfer occurred but rather at the time of the debtor's bankruptcy.

It should be underscored that the Hygrade case did not involve a valuation of collateral for the purpose of determining whether a preference had been received. In Hygrade the essential question presented was not whether a preferential transfer resulted from the assignment; rather the question was whether the trustee was limited in his recovery to the value of the property at the time of transfer. By ruling that the trustee could recover the increased value of the policy at maturity, however, the court emphasized the effect of the transfer as of the time of bankruptcy. Hygrade, therefore, might be interpreted to stand for the proposition that a transfer to a creditor who is fully secured at the time of the transfer may be invalidated to the extent that the creditor is not fully secured by collateral as valued on the date of bankruptcy. See Tait & Williams, Bankruptcy Preference Laws: The Scope of Section 547(c)(2), 99 Banking L.J. 55, 64 n.28 (1982). It is submitted that such an interpretation of Hygrade is erroneous. The case stands solely for the proposition that if the transfer of the collateral itself is voidable, the bankruptcy trustee may recover the full value of the collateral, including any appreciation in such value following the transfer.


154 It is arguable that the effect of a payment on a claim that is fully secured at the time of the transfer should be measured on the transfer date. Because the payment operates to increase the debtor's equity in the property securing the claim, the transfer does not operate to deplete the debtor's estate. See Gilbert v.
uncertain, the bankruptcy trustee should have the burden of proof on the issue of the value of the collateral.\(^\text{155}\)

In an IDB financing to enable the project's construction, the project prior to completion will likely be valued at less than the total IDB indebtedness. If, as is usually the case, proceeds from the IDB issue are held in escrow for construction withdrawals by the company, and the funds so held are pledged to secure the IDBs, then the total of such funds must be added to the value of the uncompleted project to ascertain the value of the bondholders' total collateral security. When the aggregate of those values is less than the outstanding IDB indebtedness, the bondholders' claims are only partially secured.\(^\text{158}\) Section 506(a) of the Code classifies the partially secured claimant as the holder of two separate claims: a secured claim to the extent of the collateral value, and an unsecured claim for the amount of the total claim in excess of such value.\(^\text{157}\) If the bondholders' claims are undersecured on the date as of which valuation is determined, current case law indicates any pre-bankruptcy payments by the company will in the absence of sufficient contrary evidence be presumed to have been applied by the bondholders to the unsecured portion of their claims and therefore susceptible to section 547 avoidance.\(^\text{158}\)

Payments from the proceeds of validly pledged property do not effect a preference and the burden is upon the bankruptcy

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\(^\text{156}\) See supra notes 144-58 and accompanying text.


In a case under the former bankruptcy laws, the court ruled that when the security held by the bond trustee was insufficient in value to pay the bondholders, a payment made to the trustee for the bondholders' benefit while the corporate debtor was insolvent, which was to pay interest and retire matured bonds, was voidable as a preference. Mercantile Trust Co. v. Schlafly, 299 F. 202 (8th Cir.), cert. denied, 266 U.S. 614 (1924).
trustee to show that the payments were not made from such proceeds. Accordingly, any payments received by the bondholders from the company's sale of, or the bond trustee's foreclosure upon, the property should not give rise to a preference claim if the mortgage was validly perfected and not otherwise subject to avoidance under section 547.

IV. CIRCUMVENTING THE PREFERENCE PROBLEM

A. Innovations in the Marketplace

Today's inflationary economy has rendered even tax-exempt interest rates prohibitively expensive to many companies, and has decreased the amount of capital available for investment in debt obligations generally. In order to gain renewed access to the marketplace at feasible interest rates, therefore, several innovative approaches have been devised. One such approach is

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153 One recent innovation is municipal bond insurance. The insurance guarantees the payment of principal and interest only on certain new issues of municipal bonds. Generally, the IDB issue must be investment grade in order to qualify for the insurance. However, it enables financially sound issuers of small to medium sized IDB issues to appeal to a broader market, which helps reduce interest cost. Two firms that currently offer municipal bond insurance are Municipal Bond Insurance Association and American Municipal Bond Assurance Corporation.

Two other methods of enhancing the security behind IDBs are a bond purchase agreement and an irrevocable loan commitment. Pursuant to a bond purchase agreement, a bank or some other financially secure institution agrees to purchase the IDBs upon the failure by the company to pay when due any installment of principal or interest. An irrevocable loan commitment obligates the bank or other institution to lend money to the company for the sole purpose of paying installments of principal and interest on the IDBs in the event that funds are not otherwise available to the company for that purpose. See Baron, Debt Supported by Irrevocable Letters of Credit, Irrevocable Commitments and Note Purchase Agreements, Fixed Income Investor, June 21, 1980.

Although an analysis of the bankruptcy implications of these two methods is beyond the scope of this article, it would appear that both methods afford protection to bondholders against recovery by a bankruptcy trustee of payments made to them. The payment of the purchase price under a bond purchase agreement is not made from company funds, and therefore such a payment would not entail any transfer of the company's property. In the case of an irrevocable loan commitment, a bankruptcy trustee might contend that payments to the bondholders
the addition of a new participant to IDB transactions in the form of a bank or other financially secure lending institution (the "bank"). The role of the bank is to further assure payment of the IDBs through the issuance of a letter of credit pursuant to which funds are made available to the bond trustee to pay installments of principal and interest when due to the bondholders.

The benefits accruing from the bank's participation through the letter of credit are significant. First, the credit of the bank is substituted for the credit of the company. Second, the introduction of the strong credit of the bank may permit the rating of IDB issues which otherwise might not receive an investment grade rating. Although the first benefit in itself significantly increases access to the marketplace and therefore lowers interest costs, a rating is even more effective in accomplishing those ends.

IDB ratings are primarily supplied by two major services: Moody's Investors Service, Inc. and Standard & Poor's Company. Normally both services will, for a fee, analyze the credit-

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The SEC recently addressed the issue of whether letters of credit issued by domestic branches of foreign banks qualify for the exemption from registration available to domestic banks. In general, the SEC has advised that it would not recommend enforcement action as a result of failure to register letters of credit issued by foreign bank branches in the United States to secure payment of securities that would otherwise be exempt from registration under the Securities Act of 1933. See Barclays Bank Int'l, Ltd. [1981-82 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 77,080 (1982) (letter of credit securing IDBs exempt from registration); National Westminster Bank, Ltd. [1981-82 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 77,081 (1982) (letter of credit securing non-exempt notes subject to registration); Societe Generale—New York [1980-81 Transfer Binder] FED. SEC. L. REP (CCH) ¶ 77,775 (1981) (letter of credit securing IDBs exempt from registration). See also supra note 32.

162 See infra note 163 and accompanying text.

163 Although their role in the marketplace is relatively minor compared to Standard & Poor's Corporation and Moody's Investors Service, Inc., the two
worthiness of an obligor and the terms of the specific financing
and will give an obligation an investment "rating" based upon that
analysis. Among other things, these ratings give un-
sophisticated investors a benchmark to determine the attract-
viveness of a potential investment against an objective
standard.\textsuperscript{184} In fact, ratings are required by certain institutional
investors, either as a matter of law or because of the particular
institution's internal policy. The ratings are based, in varying
degrees, on at least three considerations: the nature of the
obligation, the likelihood of default, and the protection afforded
to, and relative position of, the bondholder in the event of liqui-
dation or reorganization under the bankruptcy laws or other
laws affecting creditors' rights and remedies.

As a condition to rating an IDB issue secured by a letter of
credit, the rating agencies have required an opinion of counsel
with regard to, among other things, the potential for recovery
by a bankruptcy trustee of payments made to the bondholders
either from monies paid to the bond trustee by the company or
from monies drawn by the bond trustee under the letter of
credit. The required opinion must state that, in the event of
bankruptcy of the company or the issuer, the bondholders would
not be subject to a loss of any principal or interest because of a

\textsuperscript{184} A rating is a current assessment of the credit-worthiness of an obligor (in
the case of an IDB secured by a letter of credit, the bank) with respect to a
specific debt obligation. The bond rating is not a recommendation to purchase,
sell or hold a security, inasmuch as it does not comment upon market price or
suitability of the security for a particular investor. Ratings range from AAA
(Standard & Poor's) or Aaa (Moody's), the highest rating, which indicates that the
capacity of the obligor to pay interest and repay principal is extremely strong and
that the investment is judged to be the best quality, to CC (Standard & Poor's) or
Ca (Moody's), a low rating, which indicates that the obligations are highly
speculative. Ratings of C (Standard & Poor's) and D (Moody's) are assigned to
obligations on which no interest is being paid.

Bonds that are rated in the four highest categories—AAA, AA, A and BBB
(Standard & Poor's) or Aaa, Aa, A and Bbb (Moody's)—are generally recognized
as "investment grade," and securities rated below BBB are generally considered
speculative. The term "investment grade" was originally used by various
regulatory bodies to connote obligations eligible for investment by various
regulated institutions, such as banks, insurance companies, and savings and loan
associations. Over time, this term has gained widespread usage throughout the in-
claim that payments to them constituted a voidable preference under the Code.\footnote{In addition to an opinion dealing with voidable preferences under the Code, the rating agencies have also required that counsel's opinion address the possible application of Twist Cap, Inc. v. Southeast Bank of Tampa (\textit{In re Twist Cap, Inc.}), 1 Bankr. 284 (Bankr. M.D. Fla. 1979) to the financing being rated. In \textit{Twist Cap}, a bank had issued several letters of credit on the debtor's behalf that were payable to two unsecured creditors of the debtor. To secure its rights to reimbursement from the debtor for any sums that it might be required to pay under the letters of credit, the bank obtained a security interest in substantially all of the debtor's assets. The debtor filed for relief under Chapter XI of the Bankruptcy Act and immediately sought to enjoin the bank from honoring the letters of credit. The bankruptcy court issued a temporary restraining order against the bank on the grounds that the effect of the bank's honoring of the letters of credit would be to convert the unsecured claims of the beneficiaries of the letter of credit into a secured claim of the bank. To allow the unsecured creditor to receive payment on their prepetition claims, the court stated, would amount to "an impermissible preferential treatment of them" and would be "counterproductive to the debtor's efforts to obtain rehabilitation." \textit{Id.} at 285. \textbf{But see} Page v. First Nat'l Bank of Maryland (\textit{In re Page}), 18 Bankr. 713 (D.D.C. 1982) (district court vacated bankruptcy court's order enjoining beneficiary from cashing letter of credit even though bank that issued letter had lien upon substantial assets of Chapter 11 debtor to secure bank's reimbursement rights). For an analysis of stand-by letter of credit in the wake of the \textit{Twist Cap} decision, see Baird, \textit{Stand-by Letters of Credit in Bankruptcy}, 49 U. Chi. L. REV. 130 (1982).

The likelihood, however remote, of a court issuing a temporary restraining order that would delay payments to bondholders is seriously considered by the rating agencies in its analysis of IDB issues. Unless the agencies can rely on an opinion of counsel that the bankruptcy trustee would have nothing to gain by enjoining or restraining draws under the letter of credit, they will not assign a rating on the basis of the bank's credit alone, which is likely to have a significantly negative impact on the rating assigned to the IDBs. \textbf{See} Baron, \textit{Debt Supported by Irrevocable Letters of Credit, Irrevocable Commitments and Note Purchase Agreements}, Fixed Income Investor, June 21, 1980.

Standard & Poor's Corporation has recently advised that it will base its analysis on the bank's credit alone where the IDB financing is structured in one of the following three ways: (1) where neither the bondholders nor the bank are secured by assets of either the company or any other party to the financing; (2) where both the bondholders and the bank are secured by the same collateral (Standard & Poor's will not want to undertake comparing the values of different collateral); or (3) the bondholders are secured, but the bank is unsecured. In addition, the bank must waive all legal or contractual rights to setoff against balances}
reserve fund method; and (4) the stand-by letter of credit method. The paragraphs that follow will discuss and analyze each of these proposed methods and will assess the extent of actual protection afforded.

B. Analysis of Methods to Avoid Preference Attack

By structuring an IDB financing imaginatively, the threat of a successful preference attack in the event of the bankruptcy of the company or the issuer may be substantially reduced, if not altogether eliminated. In doing so, counsel should endeavor to remove the possibility of occurrence in the financing of one or more of the elements of a preference. It should be emphasized that none of the methods described below has been tested in the courts and therefore legal opinions as to their efficacy necessarily should be qualified as the reasoned opinion of counsel.

1. Multiple Draw Method. A method now employed in some IDB financings to mollify the preference concerns of rating agencies entails the use of a “live letter of credit.” Under this

of the company or any other party to the financing. See Baron, Bank-Supported Debt, Credit Week, January 25, 1982.

The term of the letter of credit may be coextensive with the term of the IDBs, as is generally the case when the multiple draw method is used. In other situations, the letter of credit may remain in effect for only a portion of the term of the IDB issue. For example, an IDB issue maturing in 20 years may have a letter of credit securing payment of principal and interest only for the first 5 years of the issue, or may extend for an initial term of 1 year from the date of issuance of the IDBs with options in the bank or the company to renew the letter of credit annually for additional one-year terms.

The rating on the IDBs based on the letter of credit applies only during the period that the letter of credit is in effect. Depending on the specific financing, the various participants (including the rating agencies, the underwriter, and when there is a limited number of sophisticated investors, those investors) will require that the IDB documentation provide for the occurrence of certain events if the letter of credit expires or is terminated prior to full payment of the IDBs. The IDB documents may provide, for example, that the interest rate on the IDBs will increase automatically in accordance with some predetermined formula to reflect the increased risk. Moreover, the bondholders may be given the option to sell the IDBs to other purchasers located by the company or to require the company to purchase the IDBs from them.

A question might be raised whether the transfer of the company’s funds to purchase IDBs that are put to it by the bondholders at the time of the expiration of the letter of credit could be invalidated under § 547. It seems reasonable to conclude that the payment constitutes a contemporaneous exchange for new value that is excluded from preference concerns, § 547(c)(1)(A)-(B) (Supp. III 1979), rather than a transfer on account of an antecedent debt. By payment of the pur-
method, the bond trustee is authorized and directed to draw on the bank issuing the letter of credit at the time each installment on the IDBs becomes due and in the amount of each such installment payment. The bank, in turn, looks to the company to reimburse it for the amount of each installment draw-down under the letter of credit. In effect, therefore, it is the bank that, for a fee, assumes the risk of nonpayment by the company and of later preference attack should either the company or the issuer become a debtor in bankruptcy.167 This method seeks to insulate the bondholders from the second element of a preference. It is based on the premise that the transfer to them of monies drawn under the letter of credit is not "property of the debtor," but rather is property of the bank.

It would appear that this method is soundly reasoned and should effectively protect the bondholders from section 547 avoidance actions to recover payments to them under the letter of credit. The reasoning adopted by the bankruptcy court in Sun Railings, Inc. v. Silverman (In re Sun Railings, Inc.)168 lends support to this conclusion. There the debtor owed a judgment creditor $88,000. As a partial payment to the creditor, the debtor borrowed $40,000 from a third party, who issued directly to the creditor a check earmarked for payment of the debtor's obliga-

chase price, the company acquires the IDB, becomes a bondholder and is vested with the same rights as other bondholders. The payment by the company is not made on account of any debt that it owes under the financing agreement, nor does the payment extinguish the debt of the issuer under the IDB purchased by the company. The acquisition by the company of IDBs issued on its behalf is contemplated by I.R.C. § 103(b)(9) (1981), which provides that interest income on an IDB during any period that the IDB is held by the company is not exempt from federal taxation.

Despite the fact that a short-term letter of credit does not cover the IDBs to maturity, it may be extremely useful in several circumstances. For example, it may be used to secure payments of the IDBs during the construction or start-up period, when risk of failure of the project is greatest. It may also be used in a situation where the company needs to generate capital immediately, but existing interest rates on IDBs without enhanced security would be prohibitive. In this latter case, the company has use of the capital for a specified period, during which, if the bond market does not improve and the interest rate that will take effect upon the expiration of the letter of credit is still prohibitively high, it can attempt to obtain alternate financing. When the company has the discretion to terminate the letter of credit and thereby trigger a long-term interest rate, the company may take advantage of improved market conditions as soon as they occur.

167 See Miller v. Fisk Tire Co., 11 F.2d 301 (D. Minn. 1926).
168 5 Bankr. 538 (Bankr. S.D. Fla. 1980).
tion. Concluding that the payment to the creditor was not a transfer of "property of the debtor," the court observed:

When a third party loans [sic] money to a debtor for the specified purpose of repaying a designated debt, the money never becomes part of the estate available for distribution to all creditors and, therefore, no preference is created. . . . [The transaction here involved] is nothing more than the substitution of one creditor for another and did not diminish the estate available to the creditors.\(^{169}\)

If the company's estate has been depleted preferentially under the multiple draw method, the depletion can be traced to the transfer of funds by the company to the bank as reimbursement for the bank's payment to the bondholders.\(^{170}\)

\(^{169}\) Id. at 539. Accord In re Henry C. Reusch & Co., Inc., 44 F. Supp. 677 (D.N.J. 1942); Grubb v. General Contract Purchase Corp., 18 F. Supp. 689 (S.D.N.Y. 1937), aff'd, 94 F.2d 70 (2d Cir. 1938). See also National Bank v. National Herkimer County Bank, 225 U.S. 178 (1912) (payment of bankrupt's debt by endorser on his obligation is not preferential); Huddleston v. Chestnut (In re Rector), 14 Bankr. 1008 (Bankr. E.D. Tenn. 1981) (funds that debtor's former husband was required to pay into court registry to pay court reporter fees and debtor's attorney fees in divorce proceeding were not voidable because funds were not property of the debtor and were earmarked for specific purpose).

In Inter-State Nat'l Bank v. Luther, 221 F.2d 382 (10th Cir. 1955), the court emphasized the importance that the third-party loan be made for the specified purpose of repaying a designated debt. Finding that the debtor's payment of the creditor's debt by a third-party loan was preferential under the facts there presented, the court observed: \[T\]here is nothing in the record to indicate that the [third party] intended that its loan would be used to pay the [creditor's] note, or for that matter that it knew of the existence of any such note. 221 F.2d at 393 (emphasis added).

\(^{170}\) It is conceivable that a bankruptcy trustee might contend that draws under the live letter of credit are in effect loans to the company, the proceeds of which the company disburses to the bond trustee, resulting in a diminution of the company's estate. Such a contention would be similar to that urged upon but rejected by the court in Hoffer v. Marine Midland Trust Co., 294 F. Supp. 187 (S.D.N.Y. 1968). There a bank creditor was confronted with a corporate debtor which was suspected to be insolvent. The bank arranged to make a loan to the debtor's president, who had guaranteed the debtor's obligations to the bank, in precisely the amount owed by the debtor. The debtor's president, in accordance with its agreement with the bank, in turn lent the money to the debtor and simultaneously caused the debtor to satisfy its obligations to the bank. As a result, the president substituted himself as the principal debtor to the bank in place of the corporation. When the corporation later filed bankruptcy, the bankruptcy trustee sought to recover the payment to the bank as a preference. Rejecting the trustee's assertion that there had been a depletion of the corporate debtor's estate in the amount of the payment, the court emphasized that the loan
The employment of a live letter of credit is currently preferred by the rating agencies. Because all payments to bondholders are made from draws by the bond trustee on the letter of credit, the sole issue involved is whether such draws could be recovered as preferences in the event either the company or the issuer becomes a debtor in bankruptcy. As the discussion above indicates, it is arguable that no such recovery could occur.

From the perspective of the company, however, this method is less desirable primarily because of the cost associated with it. The multiple draw technique is cost effective only if the interest savings that result from its use exceed the bank's fee for the letter of credit itself. The costs associated with this type of letter of credit are typically high, primarily because preference risks are shifted to the bank. The bank must also handle the administrative responsibilities of paying draws to the bond trustee and of recovering reimbursement from the obligor company. In some cases the additional cost is high enough to offset the benefits, and deters the company from agreeing to the method.

2. 91-Day Prepayment Method. A second method sometimes used in IDB financings is the so-called 91-day prepayment, which entails the use of a stand-by letter of credit. Following this approach, the company is obligated to pay the

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from the bank to the president never would have been made except for the president's agreement to cause the corporate debtor's obligations to be satisfied. The effect of the transaction, the court reasoned, was the same as if the president as guarantor had taken up the corporation's note, as he was obligated to do in the event of a default, and thereby become subrogated to the bank's rights against the corporation.

Under the multiple draw method described in the text, the bank's role is closely analogous to that of the guarantor in Hoffer. No depletion from the company's estate results until the company repays the bank for draws under the letter of credit.

Although the terms of a letter of credit will vary depending on the specific financing, the letter of credit will generally fall into one of two categories—the live letter of credit or the stand-by letter of credit. In both cases, draws under the letter of credit are available to the bond trustee to make payments when due on the IDBs. The difference is that the bond trustee draws on a live letter of credit each time a payment is due to bondholders. The bank is then reimbursed by the company. With certain narrow exceptions, no payment is made to bondholders from funds other than those drawn on the letter of credit. See supra notes 167-70 and accompanying text. The stand-by letter of credit is only drawn upon when the company has not deposited sufficient funds with the bond trustee to pay fully an installment of principal and interest then due, or in other words, when the company has defaulted under the financing agreement.
bond trustee each installment payment called for under the financing agreement at least 91 days before the maturity date of the installment. The bond trustee holds the prepayment in an interest-bearing trust account for the 91-day period. If no bankruptcy case is commenced by or against the company during the period, the bond trustee disburses the monies to the bondholders. The stand-by letter of credit is called upon in the event that the company becomes a debtor in a bankruptcy case prior to the expiration of the 91-day prepayment period or, if for reasons other than bankruptcy, the company fails to make a payment of principal or interest when due to the bondholders.

To illustrate the operation of this method, assume that on January 1 the company while insolvent prepays a $50,000 quarterly installment of interest that matures on April 15. On January 15 the bond trustee disburses to the bondholders a $50,000 quarterly installment of interest which matured on that date but which was prepaid by the company on October 1 of the preceding year. Within 90 days after the January 1 prepayment and prior to the April 15 date on which the bond trustee is scheduled to disburse the funds to the bondholders, the company files a voluntary petition under Chapter 7 of the Code.

Although the January 15 disbursement to the bondholders occurred within 90 days of bankruptcy, the bankruptcy trustee would be unable to recover that payment because it was transferred to the bond trustee on October 1 of the previous year, and therefore would not be a transfer of company property made on or within 90 days of the date of the filing of the petition. With respect to the January 1 prepayment, the bankruptcy trustee could recover the $50,000 in the hands of the bond trustee if each of the seven elements under section 547 are satisfied. However, as the result of the company's bankruptcy, the bond trustee would be authorized under the indenture to accelerate payment of the unpaid balance of the IDBs.\(^ {172} \)

\(^ {172} \) A provision in an executory contract that permits any modification or termination of a right or obligation under the contract upon the commencement of a bankruptcy case is referred to as an "ipso facto" clause, see H.R. Rep. No. 95-595, 95th Cong., 1st Sess. 348-49, reprinted in U.S. Code Cong. & Ad. News 5963, 6304-05, and is generally unenforceable in bankruptcy. 11 U.S.C. § 365(3) (Supp. III 1979).

To the extent that a provision authorizing acceleration of payments due under a contract upon the bankruptcy of the obligor is deemed to be an ipso facto
draw down that amount under the letter of credit to pay the bondholders' claims in full, and could turn over the $50,000 in its hands to the bankruptcy trustee. The bondholders, therefore, would be protected and their claims fully satisfied.

This method seeks to overcome potential preference problems by removing the sixth element of a preference. As previously discussed, a transfer is vulnerable under section 547 if made on or within 90 days before the date of the transferor's bankruptcy. By causing the payment to be made at least 91 days before the maturity date of the installment due on the IDBs and the disbursement of the payment to the bondholders, it is hoped that a bankruptcy trustee would be unsuccessful in any attempt to recover such disbursements as preferences from the bondholders. If this method is relied upon, extreme care should be taken in computing the 91-day period to ensure that the 90-day period of avoidance has actually run before the bond trustee disburses the money to the bondholders. Otherwise, the essence of the method is lost. In computing the 90-day period under section 547, most courts appear to exclude the date of the filing of the bankruptcy petition and to include the date of the transfer.173

The 91-day prepayment method has been accepted by the rating agencies as providing sufficient protection from preference claims against bondholders.174 A primary shortcoming from

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173 See American Sec. Bank v. Robins (In re Horton), 15 Bankr. 403 (Bankr. E.D. Va. 1981) (holding that such an acceleration clause was unenforceable). In the illustration contained in the text, it is the IDBs that are being accelerated under the indenture and not the payments called for under the financing agreement by the company. However, because the financing agreement requires the company to pay to the issuer or its assignee amounts necessary for payment of the IDBs, the acceleration of payment of the IDBs has the effect of accelerating the payments under the financing agreement. Whether or not a bankruptcy court read into the financing agreement the ipso facto provisions of the indenture would appear to be inconsequential as far as payments under the letter of credit are concerned.

174 See Baron, Bank-Supported Debt, Credit Week, January 25, 1982; Baron, Debt Supported by Irrevocable Letters of Credit, Irrevocable Commitments and Note Purchase Agreements, Fixed Income Investor, June 21, 1980.
the company's perspective is the cash flow consideration in generating funds for deposit with the bond trustee in advance of the date on which those monies are actually due to the bondholders. The potential hardship on the company is mitigated, however, in two respects.

First, interest on IDBs is often payable semiannually, for example on June 1 and December 1 of each year. Although the company will be required to make its first interest payment on March 1 rather than June 1 in the first year, thereafter the period between interest payments will be six months (March 1 and September 1), thereby eliminating the impact of the 91-day prepayment.

Second, the financing agreement and indenture provide that during the period the funds are on deposit with the bond trustee, the company may direct and benefit from the investment of those funds. Interest earned on those investments should be equal to or at least approach the amount of interest earnings on the funds had they been otherwise invested by the company.

3. Reserve Fund Method. A third method of obviating the risk that payments to bondholders will constitute a voidable preference involves application of a combination of the theories described above. This so-called reserve fund method, which is also used in conjunction with a stand-by letter of credit, eliminates the burden on the company to make payments of principal and interest 91 days in advance of the due date for those payments. Using this method, a portion of the proceeds derived from the IDB issue are withheld and deposited into a reserve fund maintained by the bond trustee. The proceeds thus withheld and deposited into the fund are in an amount sufficient to pay the largest single principal and interest payment that will become due during the term of the letter of credit. The bond trustee is instructed to hold those proceeds in trust and to use them only for one of the following purposes:

(1) To reimburse the bondholders if they are required by the bankruptcy trustee to return any principal

175 See supra note 171.
176 If interest payments are paid semiannually, then only one payment would be vulnerable to a preference claim at any given time.
or interest payment because the payment is found to be preferential under section 547;

(2) To comply with an order of a bankruptcy court respecting disposition of the trust funds; or

(3) To use the monies to pay the next installment of principal and interest on the IDBs after a period of at least 91 days following the expiration of the letter of credit, as long as during the 91-day period there occurred no bankruptcy of the issuer or the company.

Upon the occurrence of an event of default under the indenture, whether as the result of bankruptcy or some other triggering event, the bond trustee is authorized by the indenture to accelerate the payment of the balance due on the IDBs and is directed to draw on the letter of credit in an amount sufficient to satisfy such balance.

To illustrate this method, assume that from the total proceeds of an IDB issue in the original principal amount of $5,300,000, there is deposited in the reserve fund the sum of $300,000, which represents the largest installment of interest and principal that will become due during the term of the standby letter of credit. Assume further that on May 1 the company pays to the bond trustee, and the bond trustee disburses to the bondholders, an interest payment of $300,000 and that 85 days thereafter the company files for Chapter 7 relief. The bond trustee would be authorized under the indenture to accelerate payment of the balance due on the IDBs, could draw down that amount under the letter of credit to satisfy in full the bondholders' claims and could hold the reserve fund to reimburse the bondholders in the event the bankruptcy trustee successfully avoided the company's May 1 payment to them as a preference.177

177 The indenture should direct the bond trustee to hold the reserve fund until the expiration of the statutory limitation period for preference actions under § 547. See supra note 57-60 and accompanying text. While the fund is intended to reimburse the bondholders in the event they are required to return any pre-bankruptcy payments received by them, it might effectively be used by the bond trustee as a substitute for recovery from the bondholders in exchange for a release by the bankruptcy trustee of all avoidance claims he might have against either the bondholders or the bond trustee. Furthermore, if authorized by the indenture, the bond trustee might utilize the reserve fund monies to settle all of the claims of petitioning creditors in an involuntary case (to obviate the entry of an order for relief) or to purchase the claims of the debtor's other creditors (to foreclose application of the seventh element of a preference). See In re Nina Merchandise Corp., 5 Bankr. 743 (Bankr. S.D.N.Y. 1980).
This method addresses the second element of a preference and is based on the theory that the reserve fund monies would not be "property of the debtor" within the meaning of section 547 since they are immediately and irrevocably deposited with the bond trustee solely for the applications set forth above. The IDB proceeds, it can be argued, represent property of the issuer in consideration of the issuer's sale of the IDBs. Because the issuer never makes proceeds placed in the reserve fund available to the company for acquisition or construction of the project, those proceeds never become property of the company. On the other hand, the company is required to repay the full amount of principal and interest on the IDBs under the financing agreement, including that portion withheld for the reserve fund. Moreover, the company will benefit from the application of the reserve fund to pay installments of principal and interest on the IDBs after 90 days following expiration of the letter of credit. Thus a bankruptcy trustee might assert that the company's entitlement to those reserved proceeds renders them property of the company. Regardless of whether the reserve fund monies are property of the issuer or the company, as long as at least 91 days elapse from the date of the deposit to the reserve fund without either the issuer or the company becoming a debtor in bankruptcy, the transfers to the reserve fund will be immune from avoidance by the bankruptcy trustee. Even if the deposit to the reserve fund is found to be a voidable transfer of the company's property in a bankruptcy case initiated within 90 days of the deposit, the bondholders are protected by virtue of the letter of credit standing behind the company's obligations.

118 See Huddleston v. Chestnut (In re Rector), 14 Bankr. 1008 (Bankr. E.D. Tenn. 1981) (funds which debtor's former husband was required by divorce decree to pay into court to satisfy debtor's attorney fees were not recoverable under § 547 because funds were never subject to debtor's control or disposition and were earmarked for specific purpose).

119 The indenture usually provides that if no bankruptcy of the issuer or the company has occurred through the period ending not less than 90 days after the expiration of the letter of credit, the bond trustee is instructed to apply amounts in the reserve fund to the payment of principal and interest on the IDBs. This application of the reserve fund monies benefits the company by reducing its obligations under the financing agreement.

If the term of the letter of credit and the IDBs is coextensive, then the reserve fund is held until the IDBs have been fully paid. The indenture ordinarily provides that any amounts remaining in the reserve fund after payment of the IDBs is to be returned to the company.
If a bankruptcy case is not commenced on or within 90 days of the deposit to the reserve fund, then, as noted above, the question of whether the deposit constituted a transfer of property of the company will not arise. There are, however, equally important questions. One is whether a bankruptcy trustee would be able to compel a turnover of the reserve fund monies in the hands of the bond trustee. The second is whether any disbursements made from the reserved fund to bondholders within the 90-day period before bankruptcy could be recovered as preferences. In an analogous situation, the court in In re National Public Service Corp., a pre-Code case, found that the bankruptcy trustee could not recover money in a similar fund. There the bankruptcy trustee sought to recover from an indenture trustee for debenture holders certain funds paid to the indenture trustee by the bankrupt issuer to meet the coupon interest that became due semiannually. The funds were still in the indenture trustee's hands on the date of bankruptcy because the coupons representing the sums sought to be recovered had not yet been presented for payment. The district court affirmed the bankruptcy referee's order denying recovery to the bankruptcy trustee on the grounds that the funds deposited with the indenture trustee were held in trust for the debenture holders and


If the entity is a "custodian" within the meaning of § 101(10) of the Code, § 543 enjoins him from making any disposition of property of the debtor, and requires him to turn over to the bankruptcy trustee, and to account for, any such property in his possession. 11 U.S.C. § 543(a)-(b) (Supp. III 1979). A "custodian" is defined to include a "trustee . . . under a contract, that is appointed or authorized to take charge of property of the debtor for the purpose of enforcing a lien against such property, or for the purpose of general administration of such property for the benefit of the debtor's creditors." 11 U.S.C. § 101(10)(C) (Supp. III 1979).

thus did not constitute property of the bankrupt to which the
bankruptcy trustee succeeded.\footnote{Accord Steel Cities Chem. Co. v. Virginia-Carolina Chem. Co., 7 F.2d 280 (2d Cir. 1925) (where pursuant to mortgage to secure a bond issue the debtor corporation deposited funds with an indenture trustee to pay bond coupons due on a specified date, neither the corporation nor its ancillary receivers were entitled to recover such funds because funds were held in trust).}

Equally persuasive is Creel v. Birmingham Trust National Bank,\footnote{383 F. Supp. 871 (N.D. Ala. 1974).} another a pre-Code bankruptcy case, in which the debtor corporation deposited approximately $500,000 with a bank to secure installment payments required by a judgment rendered in favor of two creditors. In accordance with a settlement agreement incorporated into the state court judgment, the bank agreed to invest the funds in time deposits (which matured on the payment dates set forth in the judgment) and to pay those installments when they became due from the deposited funds. Thereafter, the debtor assigned to its parent company all of the debtor's rights in the deposited funds and the parent company in turn agreed to insure that all payments required by the judgment were timely paid. Some three years following the assignment, the parent company was adjudicated a bankrupt. Its bankruptcy trustee sought to recover the funds remaining in the bank's possession as property of the bankrupt estate, to recover those funds transferred immediately prior to bankruptcy as voidable preferences, and to recover all funds transferred from the deposit since bankruptcy. Finding that the bank held the deposited funds in trust for the benefit of the judgment creditors and that the debtor had irrevocably parted with possession and control of the funds, the district court ruled that neither the debtor nor its bankrupt parent had any interest in the trust funds and that therefore the bankruptcy trustee's recovery must be denied.

Moreover, the bankruptcy court in Ledford v. Associates Financial Services (In re Hayes)\footnote{5 Bankr. 676 (Bankr. S.D. Ohio 1980).} found that a debtor's payment of money into a municipal court's statutory trusteeship for distribution to her creditors was an irrevocable transfer of such money by which she relinquished all rights of possession and control. The court reasoned that the funds held by the
trusteeship were in *custodia legis*, and no longer represented property of the debtor. Accordingly, the municipal court trustee's distribution of the funds to creditors within 90 days of bankruptcy was not a transfer of the debtor's property that was subject to avoidance under section 547.188 It would seem that the proceeds in the reserve fund are likewise irrevocably beyond the possession and control of the company and hence no longer property of the estate.

If, however, the debtor depositor is at liberty to use the funds or in fact uses them for purposes other than as stated in the instructions accompanying the deposit, the bankruptcy court may conclude that there was no intention to create a trust and that therefore the deposited funds are recoverable by the bankruptcy trustee. For example, in *Schloss v. Powell*,189 a pre-Code receivership case, a railroad's deposit of money in a bank, with instructions to use it to pay maturing coupons presented by bondholders of the railroad, did not in the court's view evince an irrevocable intention to impress the money with a trust for the bondholders' purposes. Likewise, in *Clark v. New York Trust Co. (In re Associated Gas & Electric Co.),*187 the trustee in a bankruptcy reorganization case sought to recover funds of the debtor that had been deposited by it to pay interest when due to the holders of the debtor's investment certificates. Because the debtor reserved the right to a return of the funds at any time from the paying agent, the court found that the debtor had not irrevocably parted with control over them sufficient to create a trust for the certificate holders.188 Furthermore, the court noted

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188 The same result was reached on similar facts in the case of *Selby v. Ford Motor Co.*, 590 F.2d 643 (6th Cir. 1979). In *Selby*, the bankruptcy trustee of a construction contractor sought to recover as preferences payments made by the debtor to its subcontractors. Under the applicable state law, all funds paid to a contractor were considered to be held in trust by the contractor for the benefit of its subcontractors. The court concluded that the statutory trust funds were not property of the debtor and denied recovery to the bankruptcy trustee. Although the case was decided under the former Bankruptcy Act, the court observed that the same result would be dictated by the current Code, which under § 541(c)(2) gives effect to a "restriction of the transfer of a beneficial interest of the debtor in a trust that is enforceable under applicable nonbankruptcy law." *Id.* at 648.

189 93 F.2d 518 (4th Cir. 1938).

187 137 F.2d 607 (2d Cir. 1943).

185 *But see* *George v. Kitchens By Rice Bros., Inc.*, 665 F.2d 7 (1st Cir. 1981) wherein the court in a case under the former bankruptcy law decided that real estate placed in trust by the debtor for the benefit of his children was not property of the estate even though the trust was revocable).
that the debtor had allowed the funds to be intermingled with other monies held by the paying agent for the debtor and that such intermingling belied the existence of a trust.

The rating agencies have indicated acceptance of this reserve fund method as a means of avoiding preference claims against bondholders. One adverse effect, however, is that it necessitates that the principal amount of the IDBs issued must be larger in order to provide for the reserve fund. However, as previously noted though in connection with the 91-day prepayment method, the funds held in reserve are invested by the bond trustee and the return on that investment will offset to some extent the increased interest costs necessitated by the additional principal added to the IDB issue. A second adverse consequence for the company is that the increased amount of debt may require increased equity investments in order for the company to attain a desirable or required debt-to-equity ratio.169

4. Stand-by Letter of Credit Method. A fourth method is similar to the two just discussed, but eliminates the necessity for both the 91-day prepayment by the company and the establishment of a reserve fund. This method involves a stand-by letter of credit, the term of which extends at least 91 days beyond the date of payment of the final installment of principal and interest that it secures. The letter of credit provides that in the event of bankruptcy by the company, the bond trustee may draw on the letter of credit to the extent of any monies paid to bondholders during the 90-day period immediately preceding bankruptcy. The amount so drawn under the letter of credit is deposited in a separate trust account and may be disbursed only for the following purposes:

(1) To reimburse the bondholders if they are required by the bankruptcy trustee to return any principal or interest payment because the payment is found to be preferential under section 547; or

(2) To comply with an order of a bankruptcy court respecting the disposition of the trust funds.

Draws under the stand-by letter of credit are also available to the bond trustee to pay principal and interest due on the IDBs when there has been a failure by the company to pay such

amounts, whether the default is the result of bankruptcy or of some other cause.

To illustrate this method, assume that on January 1 the company while insolvent makes the final installment payment of principal and interest on an issue of IDBs and that 85 days following the January 1 payment the company files for relief under Chapter 7 of the Code. The bond trustee under the indenture would be authorized to draw on the letter of credit in an amount equal to the January 1 payment and deposit that amount in a separate trust fund. In the event the bankruptcy trustee avoids the January 1 transfer because each of the seven elements of section 547 is satisfied, the bond trustee could reimburse the bondholders out of the trust fund for amounts recovered by the bankruptcy trustee.

Under the reasoning set forth in the multiple draw method described above, this structuring of an IDB transaction clearly protects the bondholders. Monies paid to the bondholders within 90 days preceding bankruptcy, if recovered by the bankruptcy trustee, are immediately reimbursed out of the trust funds available from the letter of credit and, therefore, are insulated against preference claims. The danger that principal or interest on the IDBs will go unpaid because of a preference claim is effectively eliminated.

The rating agencies have accepted this method as readily as they have the 91-day prepayment method.\textsuperscript{190} Use of the stand-by letter of credit narrows the preference issue to whether draws under the letter are voidable by a bankruptcy trustee in the event of a bankruptcy of the company. As the discussion under the multiple draw method indicates, no such preference attack should succeed because no property of the company is involved. From the company's perspective, this method may be most favorable. It eliminates the problems associated with the other three methods in that there is no early payment requirement, no need to increase the size of the IDB issue, and it is not as expensive as the live letter of credit.

Because it can reasonably be concluded that each of the four methods discussed above would result in the bondholders being protected from a preference claim in the event of bankruptcy, the method used in any given IDB financing must be determined

\textsuperscript{190} See Baron, Bank-Supported Debt, Credit Week, January 25, 1982.
by the company on a case by case basis in light of its current needs and circumstances, including the availability and cost of the letter of credit, the company's cash flow, and its debt-to-equity requirements.

V. CONCLUSION

In light of today's economic conditions, IDBs provide a cost-effective means of generating funds to finance capital improvements. With the increased use of IDBs as a financing technique, investor concerns will also increase over the possible implications of bankruptcy. In the unlikely occurrence of an issuer bankruptcy, the preference concerns of bondholders arguably are minimal. On the other hand, bondholders justifiably should be concerned with the creditworthiness of the company for whose benefit the IDBs are issued. The bankruptcy of the company could have a substantially adverse effect on the bondholders' ability to retain payments to them within the 90-day period preceding the bankruptcy case. If the bondholders are fully secured creditors because the value of the mortgaged project exceeds the amount of IDBs outstanding, the potential for successful preference claims against the bondholders in the event of a company bankruptcy is diminished. Where the security is insufficient in value and the bondholders are only partially secured, payments by the company to the bondholders during the preference period are more vulnerable to avoidance under section 547.

It is foreseeable that security enhancement devices, such as the letter of credit, will be used more often as a technique to achieve greater market access and to lower interest costs. Innovative methods of avoiding preference claims against bondholders in IDB financings through the employment of letters of credit will continue to be developed and perfected.

The four methods set forth and discussed in this article appear to be based on sound preference analyses and should effectively accomplish the intended goal of bondholder protection. On the basis of existing interpretations of the preference laws, the multiple draw and stand-by letter of credit methods should be the least susceptible to a successful preference challenge and, consequently, should provide the maximum protection to the bondholders against preference claims.