

What You Should Know About Secured Claims When a Preferential Transfer Occurs

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Scenario: A corporation obtains a loan from a majority shareholder for \$1 million and in doing so executes a promissory note and mortgage granting a lien on all of the assets of the corporation. Thereafter, the corporation defaults on the loan. The majority shareholder makes demand for the full amount of the loan. The corporation pays \$500,000 against the balance owed on the loan¹. The corporation then decides to file a Chapter 11 bankruptcy case 30 days later. The majority shareholder is still owed the remaining \$500,000, which is a secured claim. If the \$500,000 paid to the majority shareholder pre-petition is avoided as a preferential transfer and that \$500,000 in cash is returned to the bankruptcy estate, does the majority shareholder retain its secured creditor status?

The Bankruptcy Code section discussing preferential transfers is set forth in 11 U.S.C. § 547(b). 11 U.S.C. § 547(b) states that the trustee may avoid any transfer of an interest of the debtor in property - (1) to or for the benefit of a creditor; (2) for or on account of an antecedent debt owed by the debtor before such transfer was made; (3) made while the debtor was insolvent; (4) made (A) on or within 90 days...or (B) between 90 days and 1 year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider; and (5) that enables such creditor to receive more than such creditor would receive if (A) the case were a case under chapter 7 of this title; (B) the transfer had not been made; and (C) such creditor received payment of such debt to the extent provided by the provisions of this title.

According to the applicable case law on this issue, in our scenario, even if the pre-petition transfer is avoided as a preference and the cash is returned to the bankruptcy estate, the majority shareholder will likely retain its secured creditor status, so long as the majority shareholder is deemed to have a lien on the corporation's cash proceeds.

In U.S. v. Whiting Pools, Inc., 462 U.S. 198 (1983), a Chapter 11 debtor sought to require the IRS to turn over property that the IRS had levied, as a result of a tax lien, one day before the debtor's bankruptcy petition was filed. The Supreme Court held that "the reorganization estate includes property of the debtor that has been seized by a creditor prior to the filing of a petition for reorganization." Id. at 209. In making this determination, the Court stated "property of the debtor repossessed by a secured creditor...may be drawn into the [bankruptcy] estate." Id. at 206. The Court concluded that the IRS could not withhold the seized property from the debtor's efforts to reorganize because the property belongs to the debtor's bankruptcy estate until the property is sold to a bona fide purchaser at a tax sale. Id. at 211-2. The Court further explained "[w]hen property seized prior to the filing of a petition is drawn into the Chapter 11 reorganization estate, the [IRS's] tax lien is not dissolved; nor is its status as a secured creditor destroyed. The IRS...remains entitled to adequate protection for its interests, to

¹ Identifying the specific claims that could be made against the officers and directors of the corporation for deciding to pay the majority shareholder is beyond the scope of this article. In addition, whether the loan should be deemed a capital contribution instead, and therefore the claim that this majority shareholder has may only be for the majority shareholder's equity interest in the corporation equal to the capital contribution, is also beyond the scope of this article. Both of these issues, among others, must be considered by a shareholder and officers and directors of a corporation when a loan to a corporation is from a shareholder and a Chapter 11 corporate bankruptcy is later filed.

other rights enjoyed by secured creditors, and to the specific privileges accorded tax collectors.”
Id.

In conclusion, in our scenario, if the transfer of \$500,000 pre-petition is avoided as a preference, and the cash is returned to the bankruptcy estate, the majority shareholder will likely retain its secured creditor status, assuming the majority shareholder has a lien on the debtor corporation’s cash proceeds². According to the applicable case law set forth above, when property is seized by a secured creditor prior to a bankruptcy filing and then subsequently drawn back into the bankruptcy estate, the secured creditor’s lien is not dissolved and the secured creditor keeps its status. *See, U.S. v. Whiting Pools, Inc.*, 462 U.S. at 211-2.

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² We are assuming for the purposes of this article that the loan documents do create a lien on cash and the creditor has overcome any commingling argument with respect to the cash. These issues must also be considered but are beyond the scope of this article.