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THE RECENT EROSION OF THE SECURED CREDITOR'S RIGHTS THROUGH CASES, RULES AND STATUTORY CHANGES IN BANKRUPTCY LAW

James J. White*

I. THE RESTRICTIONS

One can view the law of creditors' rights as a series of cycles in which alternatively the rights of the creditor and then those of the debtor are in ascendancy. Looking back through American legislative history, one sees both the state legislatures and the Congress intervening on behalf of debtors in a variety of ways on many occasions. An early example of such intervention was the enactment, particularly in the Midwest and West, of generous exemption laws1 that removed a variety of property beyond the reach of general creditors. A second example is the enactment of usury laws, which continue to be a substantial restriction on the rates that creditors can charge to consumer debtors.2 Other ex-


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1 In 1871, a Louisiana debtor could exempt as much as $18,000 worth of property and a Kansas debtor could exempt more than $6,200 worth of property. See P. Coleman, DEBTORS AND CREDITORS, 1 N. Am. 25 (1974). See also Comment, Debtor Exemption Laws and the Farmer: Suggestions for Judicial Reform, 11 U.C.D.L. Rev. 573, 573-78 (1978) (while now often rendered obsolete by inflation and technological advances, exemption statutes were generally commensurate with the living standards at the time of their enactment).

amples are laws giving mortgagors rights to redeem property after foreclosure and laws providing for upset prices at foreclosure sales. These legislative attempts to protect certain debtor interests often have been frustrated by the clever devices of creditors' lawyers. Thus, some of the restrictions on foreclosure and redemption periods were met by deeds of trust with explicit powers to sell. Usury laws have been circumvented by the advocacy of the time-price doctrine and by the substitution of a variety of fees and charges in lieu of interest. Thus, if one carefully examined the law of most states, one would find a continuous cycle of hard times, debtor complaint, legislative response, and creditor attempts at circumvention.

It is my thesis that from the election of President Johnson in 1965 until the passage of the Bankruptcy Reform Act in 1978, we have witnessed one-half of such a cycle. During that time Congress enacted eight titles of the Consumer Credit Protection Act. Various parts of that Act protect debtors against certain

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4 A vestige of the Great Depression, the fixing of a minimum upset price at which the land must be bid in if the sale is to be confirmed was first established judicially. See Suring State Bank v. Giese, 210 Wis. 489, 246 N.W. 556, 557 (1933). While somewhat limited by subsequent decisions, the underlying principle has been preserved to some extent by statute. See generally G. Osborne, G. Nelson & D. Whitman, Real Estate Finance Law 466-71 (1979) (describing the conducting of a foreclosure sale, including the nature and purpose of an upset price).


6 See Jordan and Warren, A Proposed Uniform Code for Consumer Credit, 8 B.C. INDUS. & COM. L. REV. 441, 443 (1967); Kripke, Consumer Credit Regulations: A Creditor-Oriented Viewpoint, 68 COLUM. L. REV. 445, 452-54 (1968) (discussing the usefulness of the time-price doctrine in the growth of credit selling as a means of avoiding usury restrictions). Despite substantial criticism, the time-price doctrine remains viable. See R. Speidel, R. Summers & J. White, Commercial and Consumer Law 447 (1981). See also Jordan & Warren, The Uniform Consumer Credit Code, 68 COLUM. L. REV. 387, 396 (1968) (charges such as brokerage or investigation fees, while technically not interest, effectively increase the return to the lender).

forms of garnishment, restrict the collection activities of professional debt collectors, require certain credit-price disclosures to consumer-debtors, and impose a set of rules upon those that conduct consumer electronic fund transfers. In the same spirit of consumer protection, the Uniform Consumer Credit Code was recommended for adoption in the various states by the National Conference of Commissioners on Uniform State Laws, first in 1968, and then in 1974 as amended to conform with the federal Truth-in-Lending Act. Designed comprehensively to regulate loan and sale credit up to $25,000 to individuals for personal, family, household, or agricultural purposes, various provisions include uniform disclosure requirements, ceilings on charges, and restrictions on contract terms and enforcement rights. Some states, such as Iowa and Wisconsin, passed legislation even more solicitous of the consumer. Wisconsin, for instance, specifically authorized class actions for alleged violations, made Truth-in-Lending Act disclosures applicable in a wider range of transactions, placed additional restraints on creditor collections activity, and expanded the UCCC "cooling off period" beyond credit sales consumated in the home.

One can argue that the debtor portion of the cycle reached

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Currently only ten states have adopted the Uniform Consumer Credit Code in any form. For a description of its provisions and state variations, see 1 CONSUMER CREDIT GUIDE (CCH) ¶ 4770.

* IOWA CODE § 537 (1983).

* For a discussion of the legislative history of the Wisconsin Consumer Act, see Davis, Legislative Restriction of Creditor Powers and Remedies: A Case Study of the Negotiation and Drafting of the Wisconsin Consumer Act, 72 MICH. L. REV. 1, 3 (1973).


* See Barrett & Jones, supra note 15, at 498-501.

* See Heiser, supra note 16, at 448-49.
its apogee with the enactment of the Bankruptcy Reform Act (the Code) on November 6, 1978. The Code contained little that was directly beneficial to secured creditors' interests, and much that was damaging. It was passed over the vigorous objection of some creditors and with the reluctant cooperation of others. One suspects that those who cooperated did so out of a fear that they would have fared even worse had they not presented their arguments to the Congress. The Bankruptcy Reform Act had been before the Congress in various forms since 1973. It is improbable that the Code in its current form could have made it through any Congress prior to 1978 or any since the election of President Reagan.

This expansion of debtors' rights beginning in 1965 came on the heels of one of the most important codifications of creditors' rights in the 20th century. It is most fitting that it occurred in the last year of the Johnson administration, which was notable for its efforts, embodied in the Civil Rights Act of 1964 and in the same year in the Interstate Commerce Commission Reorganization Act of 1966, to create an American economic society based on greater freedom and equality for all. The 1978 Bankruptcy Code is a part of this larger movement. It did not end the movement. Indeed, it may be that the full impact of the Code will not be felt for some years to come.

19 During the subcommittee hearings, some creditors strongly opposed the Bankruptcy Reform Act. See, e.g., Hearings on HR 31 and HR 32 before the Subcommittee on Civil and Constitutional Rights of the House Committee on the Judiciary, 94th Cong., 2nd Sess. 1737 (1976) (testimony of Franklin Cole, Chairman of Walter Heller & Co.) (proposed Act will not benefit bankrupts or unsecured creditors and will injure small and medium-sized businesses by drying up an already limited source of financing); id. at 1824 (testimony of Eli Silberfield, general counsel for the National Commercial Finance Conference) (proposed Act increases the cost of financing and therefore makes it unavailable to small businesses).

Other creditors said that they favored the Act, but would make significant changes. See id. at 1776 (testimony of Martin Pinsen, representing the National Association of Small Business Investment Companies (SBICs)) (favoring the Act, but desirous of excluding SBICs from the category of affiliates since affiliates' claims are subordinate to those of other creditors); id. at 1666 (testimony of Richard Kaufman, National Association of Credit Management) (bill is fundamentally sound but creditors should have more control in bankruptcy proceedings and be able to select a trustee and elect a creditors' committee in rehabilitation chapter cases); id. at 1775 (testimony of Patrick Murphy) (Act does not sufficiently clarify the rights of secured creditors in rehabilitation proceedings).

See also Reisman, The Challenge of the Proposed Bankruptcy Act to Accounts Receivable and Inventory Financing of Small-to-Medium-Sized Businesses, 83 Com. L. J. 169, 211 (1978) (proposed Act creates a “minefield for the unwary creditor,” encourages debtors to declare bankruptcy, and will severely diminish the flow of credit, especially to small businessmen).

interests, namely, the enactment of Article 9 of the Uniform Commercial Code. In the 1950's and through the middle of the 1960's, all of the states but Louisiana enacted Article 9 of the UCC. By validating provisions such as after-acquired property clauses and the secured creditors' rights with respect to future advances, and by granting a simple, inexpensive and precise

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A tabular record of the Code's enactment in the various states can be found in 1 U.L.A. 1-2 (Supp. 1982). Thirty-two states now have adopted the 1972 revisions of Article 9. See Schimberg, Secured Transactions, 36 Bus. Law. 1347, 1347 (1981). Unless otherwise noted, all citations to the Uniform Commercial Code (UCC) will be to the 1972 version.

Article 9 permits creation of a "floating lien" in accounts receivable, inventory, proceeds or similar property other than nonaccession consumer goods acquired subsequent to the formation of the original security agreement that secures any or all obligations covered by that agreement. See U.C.C. §§ 9-204, -306 (1972). Although a floating lien can be subordinated to a conflicting purchase money security interest pursuant to U.C.C. § 9-312 (3)-(4) (1972), the Article 9 provisions generally recognize a broader after-acquired property interest than existed prior to the adoption of the Uniform Commercial Code. Several states refused to recognize floating liens at all, apparently in the belief that to ensure the protection of creditors a borrower should not be allowed to encumber all his assets. See U.C.C. § 9-204 comment 2 (1972). Many states required successive filings with each acquisition of property by the debtor, and others required new chattel mortgages or similar security devices as well as additional filings for each transaction if a creditor was to have effective rights even against the debtor. The secured party might also be required to exercise extensive control over his collateral to maintain his security interest; U.C.C. § 9-205 abolishes this "policing" rule. Section 9-204(1) places a security interest arising out of an after-acquired property clause on an equal footing with a security interest in collateral in which the debtor has rights at the time the security agreement is negotiated without any further action by the secured party. See U.C.C. § 9-204 comment 1 (1972).

Although few jurisdictions went so far as to invalidate future advance agreements, a pre-Code prejudice existed against such arrangements comparable to that against after-acquired property clauses. Frequently the original security agreement was required to specify the amount and disbursement time of the advances for them to be valid. See U.C.C. § 9-204 comment 5 (1972). Section 9-204(3) authorizes future advances, requiring only that the obligation be one covered by the security agreement. Section 9-312(7) in general provides that the priority of a subsequent advance relates back to the original filing when in conflict with another security interest, regardless whether made pursuant to commitment.

Buyers other than in the ordinary course of business are permitted to take free of the security interest only in the rare instance when the advance is not made pursuant to a commitment entered into prior to the forty-sixth day after the purchase and either the advance is made more than forty-five days after the purchase or the secured party knows of the purchase. U.C.C. § 9-307(3) (1972). Similarly, lien creditors can subordinate future advances only if they are made more than forty-five days after the lien arises and then only if they are made with knowledge of the lien and not subject to a prior commitment made without knowledge. U.C.C. § 9-301(4) (1972). This forty-five day period corre-
method of acquiring priority, Article 9 expanded and confirmed personal property secured creditors' rights.

Why the cycle reversed itself in the mid 1960's is unclear. Unlike many prior debtor cycles that were stimulated by the desperate needs of debtors in the grips of recession, this cycle commenced in a time of relative prosperity. On a superficial level one might argue that the reversal is but an additional manifestation of the anti-establishment views of the post-Vietnam era, of George McGovern, and of the left wing of the Democratic party. This is too simple, for one sees seeds of the movement with President Johnson and his “great society.” History may conclude that President Johnson, like President Jackson 130 years previously, was bringing southern populism to Washing-

sponds to the Federal Tax Lien Act of 1966 provision regarding protection of advances made after the filing of tax liens. See I.R.C. § 6323(c), (d) (1976). For further discussion regarding the Federal Tax Lien Act of 1966's expansion of secured creditor's rights, see infra note 24.

*U.C.C. § 9-201 (1972)* grants a secured creditor, even an unperfected secured creditor, priority over an unsecured creditor without a lien. While § 9-301(1)(b) (1972) provides that an unperfected secured creditor is subordinate to the rights of a lien creditor, by negative implication a prudent secured creditor can avoid the problem simply by perfecting his security interest pursuant to the instructions specified in § 9-303 (1972). Priority among conflicting nonpurchase money security interests in the same collateral is given to the first perfected or filed, whichever is earlier, so long as there is no period thereafter in which there is neither filing nor perfection. *U.C.C. § 9-312(5) (1972).* Other rules of priority governing particular sorts of conflicting security interests are provided in other subsections of § 9-312 as well as in § 9-313 (fixtures), § 9-314 (accessions), § 9-315 (commingled goods), and § 9-306 (proceeds).

A trustee in bankruptcy has the rights of a lien creditor and is treated so under the Uniform Commercial Code. 11 U.S.C. § 544(a) (1976); *U.C.C. § 9-301(3) (1972).* Thus a prudent secured creditor can easily gain priority over the trustee in bankruptcy by perfecting his security interest.

A prudent secured creditor also can maintain his priority over federal tax liens provided he checks the files every forty-five days. If the security interest is perfected before the tax lien is filed, the secured party wins even if he had actual knowledge of the tax lien. *I.R.C. § 6323(a) (1976).* Even after notice of the tax lien is filed, the secured creditor can make disbursements before the forty-sixth day following the tax lien filing date if he has no actual knowledge of the tax lien. *I.R.C. § 6323(d) (1976).* The secured creditor also can reach after-acquired property obtained by the debtor-taxpayer within forty-five days following the tax lien filing date. *I.R.C. § 6323(c) (1976).* Article 9 has sought to preserve this priority in its rules governing conflicts between lien creditors and secured creditors.

This is a significant change from the law prior to 1966, which made any disbursement after the tax lien was filed subordinate to the tax lien. See W. Plumb, Federal Tax Liens 88 (3d ed. 1972).
ton. By the late 1960's, it seems likely that there was a confluence of all the wings of the Democratic party, from the southerners who were conservative in many respects but populists in matters of money, to the northern liberals and even radicals to whom private property was suspect. The force was so strong that even President Nixon, who hardly could have been sympathetic to the movement, supported the establishment of the National Institute for Consumer Justice. Almost annually the Congress added to the Consumer Credit Protection Act, and encroached further on traditional state creditors'-rights law. Here too, the Federal Trade Commission was emboldened to tread on the most sacred principle of all and effectively to abolish the holder in due course doctrine by its rule promulgated in 1975.

Against the background of such enactments that were overtly and intentionally contrary to creditor interests, the

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**5** The National Institute for Consumer Justice, inspired by a February 1971 presidential address calling upon "interested private citizens to undertake a thorough study of the adequacy of existing procedures for the resolution of disputes arising out of consumer transactions," was organized as a non-profit corporation in the District of Columbia in the summer of 1971. During its two-year tenure, the Institute's work focused on the problems facing consumers who suffered economic loss by paying for defective or misrepresented goods or services. See *Redress of Consumer Grievances, The National Institute for Consumer Justice* xi-xii (1973).

**6** See supra note 7. Section 123 of the Fair Credit Reporting Act of 1968, Pub. L. No. 90-321, 82 Stat. 152 (codified at 15 U.S.C. § 1633 (1970)), allowed the Federal Reserve Board to "exempt from the requirements of this part [16 U.S.C. §§ 1631-65 (1970)] any class of credit transactions within any State if it determines that under the law of that State that class of transactions is subject to requirements substantially similar to those imposed under this part, and that there is adequate provision for enforcement," thereby applying pressure on the states to revise their consumer credit laws. For a treatise extensively dealing with the evolution of state legislative regulation of consumer credit (traditional state creditors'-rights law), see B. Curran, *Trends in Consumer Credit Legislation* (1965).

**7** 16 C.F.R. § 433 (1982). The holder in due course doctrine was one of the principal devices relied upon by finance companies to assure payment by a consumer despite consumer dissatisfaction with a purchase. Under this longstanding doctrine, a seller's negotiation of a purchaser's note to a third party qualifying as a holder in due course generally prevented the purchaser from asserting any defenses to nonpayment. The FTC's rule effectively abolished the doctrine in most consumer credit transactions. See Benson & Squillante, *The Role of the Holder in Due Course Doctrine in Consumer Credit Transactions*, 26 Hastings L.J. 427, 440-42 (1974); Randolph & Whitman, *The Last Nail in the Coffin of the Holder in Due Course Doctrine*, 14 Am. Bus. L.J. 311, 311-12, 327-31 (1977).
Bankruptcy Reform Act must have seemed innocuous. The Code was a significant, though not radical, departure from that proposed by a respected Commission. To the extent that it has proved to be contrary to the interests of secured creditors, it has been so not because a specific lobbying group set out to attack secured creditors. Rather, the most serious injury to creditor interest probably will come through a combination of and a relatively subtle interaction among various parts of the Code. Nevertheless, it seems unlikely that the Code could be passed today, or that it could have been passed at any time prior to 1978.

Against that short history consider my thesis. First, I maintain that a series of changes in the law since 1965 have substantially reduced the personal property secured creditors' rights. Second, I argue that we are about to enter upon the second part of the historic cycle in which clever creditor lawyers devise novel ways of doing business, and creditors adopt new practices to minimize the impact of the law's change. Because we are not yet deeply into this phase, I necessarily will be guessing, not only about some of the consequences of the new law, but about the creditors' response to them.

Specifically, I will address six recent changes, some in the bankruptcy rules, some through the Code, and one through case law, that have diminished the rights of secured creditors. The first is the operation of the automatic stay. Second is the debtor's right to use and sell the creditors' collateral provided only that he gives adequate protection. Third is the debtor's capacity to impose a plan or reorganization on an unconsenting secured creditor in Chapter 13 or 11. Fourth are the expanded avoidance powers. Fifth is the expansion of the jurisdiction and reach of the bankruptcy court, and finally are the recent cases

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Although the Bankruptcy Code as passed does not bear any strong resemblance to the Commission's draft, many of the Commission's suggestions were preserved. See P. Murphy, Creditors' Rights in Bankruptcy § 1.05 (1980). See generally, Kennedy, Background and Overview of the Bankruptcy Code of 1978, in The Bankruptcy Reform Act of 1978 3-7 (C. Holmes ed. 1979).
that apply fraudulent conveyance law to foreclosure sales. In the second portion of the article I will identify six ways in which secured creditors may be expected to respond to these events.

A. The Automatic Stay

Prior to the last decade, no comprehensive automatic stay applied to secured creditors’ collection activities upon the filing of a bankruptcy petition. The burden was upon the debtor in possession or the trustee to prove his basis for a restraining order and to convince the court to grant him one. While the courts clearly had jurisdiction to restrain creditor activity upon the filing of any petition in bankruptcy, in practice it appears

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that the presence of injunction power was far less threatening to a secured creditor than an automatic stay that bears similar contempt powers. Because the stay was not automatic, different standards were applied by different courts in determining whether the debtor or trustee had carried his burden. Whether to grant such an order rested with the discretion of the bankruptcy judge, and one can safely conclude that many debtors did not receive restraining orders in circumstances where the automatic stay would have applied. Perhaps an even larger number of creditor activities were not stayed because the debtor or trustee failed to ask for a stay.

Between 1973 and 1976, the Rules of Bankruptcy Procedure incorporated automatic stays throughout the various types of proceedings similar to the single one now found in section 362 of the Code. Because Chapter XI was the most widely used business reorganization provision and because it provided for no stay whatsoever before the enactment of Rule 11-44, enactment of that rule was by far the most important.

In theory, and occasionally in fact, the presence of the stay does not diminish the amount a secured creditor will receive out of the bankrupt estate. If the value of the collateral exceeds


*See 2 COLLIER ON BANKRUPTCY ¶ 362.01-.03 (rev. 15th ed. 1983).*


*Several commentators, however, have speculated that seeking a blanket stay at the outset of bankruptcy proceedings, especially Chapter proceedings, was a very widespread practice and that a stay in one form or another was frequently granted. See 2 COLLIER ON BANKRUPTCY ¶ 362.01(2) (rev. 15th ed. 1983); Kennedy, The Automatic Stay in Bankruptcy, 11 U. Mich. J. L. Ref. 177, 190 n.78 (1978).*

*See supra note 7. In contrast to the Bankruptcy Act, the automatic stays provided by both the Rules of Bankruptcy Procedure and section 362 of the Bankruptcy Code immediately arise upon the filing of a petition regardless whether the petition was voluntary or involuntary; the Chapter XII automatic stay could arise only in voluntary cases. While the stay against liens in straight bankruptcy cases was less comprehensive than that applicable in debtor rehabilitation cases under the Rules of Bankruptcy Procedure, section 362 applies equally to all bankruptcy proceedings. See Kennedy, Automatic Stays Under the New Bankruptcy Law, 12 U. Mich. J. L. Ref. 3, 4-5 (1978); Kennedy, The Automatic Stay in Bankruptcy, 11 U. Mich. J. L. Ref. 177, 177 (1978).*

the debt upon the filing of the petition by an amount greater than the interest that the creditor would have collected during the pendency of the bankruptcy proceeding, section 506(b) of the Code will allow the creditor to receive that interest together with his collateral or its value.

In many cases the stay, together with the principle that an undercollateralized creditor does not receive interest pending the outcome of the bankruptcy, will mean that the secured creditor will ultimately receive less than he would have had his collateral been handed over to him on the date the petition was filed. Assume, for example, that the prime interest rate is 15%, that our hypothetical creditor is owed one million dollars, and that the collateral is worth exactly one million dollars. If the bankruptcy drags on for a year before there is dissolution, our creditor will have lost his $150,000 of interest because he receives no interest unless he is oversecured. Although he might have loaned to another at 15% for that period, he will probably receive nothing for the opportunity cost of losing the use of his money for the year's time. Thus the very presence of the stay,


The claim of an undersecured creditor is divided into two parts; it is a secured claim to the extent of the collateral's value, but any claim in excess of that amount is a separate unsecured claim. Interest on the debt is allowed only to the extent the value of the collateral exceeds the amount of the secured claim. 11 U.S.C. § 506(b) (Supp. V 1981). See also Crocker Nat'l Bank v. American Mariner Indus. (In re American Mariner Indus.), 27 Bankr. 1004, 1009 (Bankr. 9th Cir. 1983) (undersecured creditor not entitled to receive interest); In re Pine Lake Village Apt. Co., 19 Bankr. 819, 826-27 (Bankr. S.D.N.Y. 1982) (interest provision held applicable only to oversecured claims).

See Fortgang & King, The 1978 Bankruptcy Code: Some Wrong Policy Decisions, 56 N.Y.U. L. Rev. 1148, 1163 n.57 (1981). Whether a secured creditor will be compensated for his "opportunity cost" depends upon the court's perception of the nature of adequate protection. Most courts, especially bankruptcy courts, view adequate protection as solely intended to protect the secured creditor against any decrease in the value of his collateral during the interim between the filing of the petition and confirmation of a plan. See, e.g., Crocker Nat'l Bank v. American Mariner Indus. (In re American Mariner Indus.), 27 Bankr. 1004, 1009 (Bankr. 9th Cir. 1983); General Elec. Mortgage Co. v. South Village, Inc. (In re South Village, Inc.), 25 Bankr. 987, 989 (Bankr. D. Utah 1982); In re Pine Lake Village Apartment Co., 19 Bankr. 819, 823 (Bankr. S.D.N.Y. 1982). These courts take the position that because adequate protection is not meant to maintain a secured creditor in the position he could have been in but for the intervention of the stay, or to protect either the value of money or any existing equity cushion, the secured creditor with collateral appreciating or remaining constant in value has gotten
first widely used under rule 11-44 promulgated in 1974, and now applicable via section 362 to all forms of bankruptcy proceedings, will have a deleterious impact upon the secured creditor.

This change first came about by rule, but one should not minimize the impact of the Congressional enactment of the substance of the rule. Section 362 is now in the statute for all to see; it is the topic of continuous discussion in continuing education courses and in the bankruptcy literature, and it is the subject of untold cases. Doubtless this new-found prominence has brought it to the attention of debtors’ lawyers, trustees in bankruptcy, and others who will assert its protection but who might have never sought the protection of a rule.

B. Debtor's Retention, Use, and Sale of Collateral

Section 363 of the Code explicitly authorizes the debtor in possession to “enter into transactions, including the sale or lease of property of the estate, in the ordinary course of business, without notice or a hearing” and to “use the property of the estate in the ordinary course of business without notice or a hearing.” Prior to the enactment of the Bankruptcy Reform Act, the debtor in possession probably had rights similar to those expressed in section 363 in Chapter X proceedings but that was

the benefit of his bargain and is entitled to nothing more. See, e.g., General Elec. Mortgage Co. v. South Village, Inc. (In re South Village, Inc.), 25 Bankr. at 994; In re Pine Lake Village Apartment Co., 19 Bankr. at 827. One court has found that oversecured creditors eventually get their “opportunity cost” through the operation of section 506(b) and suggested that creditors concerned about undue delay should seek dismissal of the petition or conversion to liquidation proceedings. See In re Pine Lake Village Apartment Co., 19 Bankr. at 827.

Other courts have focused more specifically on language in the legislative history indicating that a secured creditor should receive in value “essentially what he bargained for.” These courts note that were it not for the stay, the creditor would foreclose and thus have the use of his money at current market rates. They argue that because part of what the creditor bargained for was the return of his money at a specified time, he is entitled to compensation for the loss of the use of his money during the interim period between the filing of the petition and confirmation. See, e.g., Metropolitan Life Ins. Co. v. Monroe Park (In re Monroe Park), 17 Bankr. 934, 940 (D. Del. 1982); United Virginia Bank v. Virginia Foundry Co. (In re Virginia Foundry Co.), 9 Bankr. 493, 498 (W.D. Va. 1981).

A search for cases dealing with section 362 and containing the words “automatic stay” showed 518 cases between January 1, 1982 and April 1, 1983.

not true either in the most common form of reorganizations, Chapter XI proceedings, or in liquidations. Although the court could stay a creditor’s repossession in Chapter XI and presumably permit the use of equipment pending the outcome of the reorganization, its right to authorize the sale of collateral or any serious use that might cause depreciation was far from certain. Thus, the bold and explicit assertion of such rights in all forms of bankruptcy proceedings greatly strengthens the debtor’s hand in negotiating with the creditor over the use and sale of such collateral.

Under section 363 the debtor in possession may use the collateral out of the ordinary course or make sales out of the course

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41 The bankruptcy court’s power to sell assets, either subject to or free from liens, was well established under the Bankruptcy Act and its Rules as well as in the accompanying case law. See Bankruptcy Act of 1898 § 70(f), (g), 11 U.S.C. § 110 (1970) (repealed 1978); 11 U.S.C. Bankr. R. 606 (Supp. V 1975) (repealed 1978); Wright v. Union Central Life Ins. Co., 304 U.S. 502, 517 (1938); Ray v. Norseworthy, 90 U.S. (23 Wall.) 116, 135 (1875). While Chapter X and Chapter XII had statutory language in sections 257 and 507 that permitted ouster of secured creditors in possession, early cases were hesitant regarding the use of cash proceeds such as rent. See, e.g., Crystal v. Green Point Sav. Bank (In re Franklin Garden Apartments, Inc.), 124 F.2d 451, 454 (2d Cir. 1941); National Builders Bank v. Schwartz (In re Moulding-Brownell Corp.), 101 F.2d 664, 666 (7th Cir. 1939). During the early 1950’s two circuit courts gave thorough consideration to the use of collateral issue with divergent results. In Reconstruction Fin. Corp. v. Kaplan, 185 F.2d 791 (1st Cir. 1950), the First Circuit ordered a turnover of the collateral based on a strong showing that the secured creditor’s position would be safeguarded and enhanced. 185 F.2d at 798. The Second Circuit adopted a somewhat more restrictive approach two years later, permitting use of collateral only when there is “a high degree of likelihood (a) that the debtor can be reorganized in accordance with the Act, within a reasonable time, and (b) the secured creditors whose security is being compulsorily loaned will not be injured.” In re Third Avenue Transit Corp., 198 F.2d 703, 706-07 (2d Cir. 1952). Subsequent decisions recognizing the difficulty in determining the likelihood of successful reorganization at the outset of proceedings substantially eroded the “Third Avenue Test.” See, e.g., In re Chicago, R.I. & Pac. R.R., 545 F.2d 1087, 1090 (7th Cir. 1976); Central R.R. v. Manufacturers Hanover Trust Co., 421 F.2d 604, 607-08 (3d Cir.), cert. denied, 398 U.S. 949 (1970). In addition, two Second Circuit Chapter X decisions permitting continued use of depreciating collateral raised grave doubt as to the viability of Third Avenue. See In re Bermec Corp., 445 F.2d 367, 369 (2d Cir. 1971); Fruehauf Corp. v. Yale Express Sys. (In re Yale Express Sys.), 384 F.2d 990, 992 (2d Cir. 1967). Finally, some Chapter XI cases permitted the continued use of collateral such as inventory and accounts receivable but only so long as the secured creditor’s rights were preserved. See Citicorp Business Credit, Inc. v. Blazon Flexible Flyer, Inc. (In re Blazon Flexible Flyer, Inc.), 407 F. Supp. 861, 863-64 (N.D. Ohio 1976) (accounts receivable); In re American Kitchen Foods, Inc., 9 Collier Bankr. Cas. 2d (MB) 537, 542-47 (D. Me. 1976).
only after a notice and hearing. Both the right to use and to sell are dependent upon the capacity of the debtor to give the secured creditor “adequate protection” as that term is defined in section 361. If the debtor in possession can convince the court that his proposal affords “adequate protection,” the debtor may proceed on his merry way without significant interference from the secured creditor.

In theory, adequate protection under section 361 should leave the secured creditor in no worse position upon dissolution or the proposal of a plan than he would have been had he received his collateral on the day the petition was filed. In fact, one suspects that it is only by chance that the secured creditor will be left in an identical position after the passage of time. A variety of the forms of adequate protection that have been approved by the courts depend upon hotly debated court determinations of the “value” of the collateral. For example, it is now commonplace for courts to refuse to lift the stay and to find that a secured creditor has “adequate protection” because there is an “equity cushion.” Because the value of collateral exceeds the debt, the court finds that the secured creditor will lose nothing by waiting. Obviously, if the court proves to be wrong about the value, or if the collateral depreciates more rapidly than the court expects, the secured creditor will be worse off at the conclusion than he would have been had he received the collateral at the

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42 The “notice and a hearing” required before cash collateral can be utilized by a trustee does not mean that an actual hearing must be held. 11 U.S.C. § 102(1) (Supp. V 1981). See also In re Sullivan Ford Sales, 2 Bankr. 350 (Bankr. D. Me. 1980).

outset. In other circumstances, the creditor stands to lose, because the debtor will have an opportunity to transform inventory or equipment into cash or other liquid assets, and ultimately to dissipate them in a vain attempt to continue the operation of the business. That is a real possibility when the debtor is permitted to use cash collateral, notwithstanding the creditor’s objection, or on the basis of an ex parte court order procured without the representation of a lazy or distant creditor.

Although I know of no empirical data to prove that the combination of sections 362, 363, and 361 leads to a lower return for the secured creditor than it would have received had it proceeded under state law to repossess and resell the collateral, that result seems inevitable. It is the hope of many business debtors to be reorganized, to come upon the dawn of new business successes. It is the dark reality that many Chapter 11’s become Chapter 7 liquidations. That being the case, it is implausible

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44 The general rule found in section 502(b)(2) states that no interest can be accrued as part of an allowed secured claim after a petition has been filed. An exception is provided in section 506(b) whereby an oversecured creditor is allowed interest on his claim, but only to the extent his claim is exceeded by the value of the collateral after recovery of any reasonable necessary costs connected with the preservation or disposal of the collateral. The amount of interest allowable under section 506(b) is not calculated until a plan is confirmed or the collateral is sold and once accrued interest on an allowed secured claim equals the amount of the excess, no further interest is allowable. Moreover, at least some courts will refuse to lift the automatic stay on absence of adequate protection grounds merely because the excess is insufficient to cover accruing interest. See Crocker Nat’l Bank v. American Mariner Indus. (In re American Mariner Indus.), 27 Bankr. 1004, 1007-1010 (Bankr. 9th Cir. 1983). But see Metropolitan Life Ins. Co. v. Monroe Park (In re Monroe Park), 17 Bankr. 934, 937-41 (D. Del. 1982); Midlantic Nat’l Bank v. Anchorage Boat Sales (In re Anchorage Boat Sales), 4 Bankr. 635, 640-44 (Bankr. E.D.N.Y. 1981). Thus, a creditor oversecured when bankruptcy proceedings commence ultimately may discover that because the value of his collateral has not kept pace with the accrual of interest and other expenses incurred by the estate, he is no longer entitled to the compensation he originally anticipated.

46 The very fact of the huge amount of litigation under § 362 suggests at least secured creditors believe they are being injured by its application.

47 For example, in the district of Utah, as of September 30, 1982, plans had been confirmed in only 43 of the 251 cases that had been filed and pending for over six months. Probably most of the remaining 208 cases (84%) have been or will be converted into Chapter 7 liquidations. See In re Colonial Ford, Inc., 24 Bankr. 1014, 1022, 1022 n.18 (Bankr. D. Utah 1982).

For a sampling of cases that started out as Chapter 11’s and have since become Chapter 7 liquidations, see Air Transport Ass’n of America v. Professional Air Traffic Controllers Org. (In re Professional Air Traffic Controllers Org.), 699 F.2d 539 (D.C. Cir.
that most collateral will expand in value during the final desper-
ate days of a business slipping from reorganization into liq-
uation.

C. Cramdowns, Chapter 11 and 13

Under Chapter 13 plans and Chapter 11 reorganizations, the
debtor essentially has the power to force any given secured cred-
itor to forego its right to repossess in return for a promise, se-
cured by the collateral, which in the court’s judgment has the
same present value as the value of the collateral. Thus if the
court concludes that a creditor with a two million dollar debt
has collateral worth one million dollars, it has the power to ap-
prove a plan over the creditor’s objection under which the credi-
tor would receive a series of periodic payments whose present
value would amount to one million dollars.

In Chapter 13 and Chapter 7 consumer bankruptcies, the
cramdown provisions operate together with section 722. That
section specifically allows the debtor to redeem certain personal
property, usually an automobile, by paying the secured creditor
the current value of the asset. Although a Chapter 7 debtor may
have to provide a lump sum equal to that value, the debtor

1983); Roslyn Savings Bank v. Comcoach Corp. (In re Comcoach Corp.), 698 F.2d 571
(2d Cir. 1983); Fanelli v. Hensley (In re Triangle Chemicals), 697 F.2d 1280 (5th Cir.
1983); Ohio v. Kovacs (In re Kovacs), 681 F.2d 454 (6th Cir. 1982); Earl Realty v. Le-
onetti (In re Leonetti), 28 Bankr. 1003 (E.D. Pa. 1983); Pearlstein v. Small Business Ad-
ministration, 27 Bankr. 153 (D.C. Cir. 1982); Kopelman v. Halvajian (In re Triangle Lab-
oratories, Inc.), 663 F.2d 463 (3d Cir. 1981); Superscope, Inc. v. Brookline Corp., No. 81-
1982).

V 1981). The statement in the text is not precisely accurate, for creditors in Chapter 11
ing gives up the right to be treated as an unsecured creditor to the extent that he is
“undersecured,” but the creditor retains a security interest in the collateral equal to the
full amount of the debt. Thus, at least in some Chapter 11 cases, a secured creditor may
avoid the consequences of an unfair cramdown by foregoing its unsecured claim and
clinging to the collateral (in rem) in the hope his evaluation of the collateral is ultimately
proven correct.

The legislative history is somewhat unclear whether lump sum payment is re-
under Chapter 13 can effectively force the creditor to continue to finance his purchase of the automobile. Formerly, the secured creditor could insist that the debtor pay the entire amount of the indebtedness to retain the automobile.49 In the absence of restrictions regarding reaffirmation such as those now found in section 524(c), he often would receive a reaffirmation by the debtor for the full amount of the debt.50 In effect, the debtor would have concluded that his automobile or other asset was worth more to him than to an independent third party. Section 722, in conjunction with Chapter 13 and section 524, deprives the secured creditor of the right to hold out for that higher subjective value allocated to the asset by a particular debtor.

These provisions are perhaps the most radical and important departure from the law and practice existing prior to the Code. Although cramdowns were possible under Chapters X and XII and in railroad reorganizations prior to the enactment of the Code,51 few businesses and no consumer debtors found themselves in such reorganizations.52 Section 1129's application of the cramdown to all business reorganizations, and section 1325's application to all Chapter 13 cases, applies a doctrine that formerly related to a minuscule percentage of all bankruptcies to the core

(citing H. Doc. 95-595 at 127, 380).


50 See H.R. REP. No. 595, 95th Cong., 1st Sess. 127, 162-64, reprinted in 1978 U.S. CODE CONG. & AD. NEWS 6088, 6123-25. Estimates of the number of reaffirmations vary, but one study found that over one-third of those going through straight bankruptcy agreed to reaffirmation of at least some of their debts with nearly half doing so because they wanted to keep the asset; another third said they wanted to pay the creditor. See D. STANLEY & M. GIRTH, BANKRUPTCY: PROBLEM, PROCESS, REFORM 59-62 (1971). In another study, over half of those going through bankruptcy had agreed to reaffirmations of debts. See H. JACOB, DEBTORS IN COURT 109-10 (1969). Once made, such a reaffirmation was enforceable. See 3 COLLIER ON BANKRUPTCY ¶ 524.03 (15th ed. 1979).


52 For instance, in the year ending June 30, 1979—the last full year the judiciary operated under the Bankruptcy Act—226,476 bankruptcy estates were filed. Only 669 were Chapter XII petitions, 63 were Chapter X proceedings, and none were railroad reorganizations. BUREAU OF THE CENSUS, STATISTICAL ABSTRACT OF THE UNITED STATES: 1981 539 (102d ed. 1981). Chapter X was exclusively for corporate debtors while Chapter XII's purpose was to provide much the same relief for individual debtors with respect to real property arrangements as Chapter X furnished corporate debtors. See 1 COLLIER ON BANKRUPTCY ¶ 0.07 (rev. 14th ed. 1974).
of bankruptcy practice, namely consumer plans and business reorganizations. Under Chapter XI of the Bankruptcy Act, courts had no jurisdiction to deal with the claims of secured creditors.\footnote{See Peitzman \& Smith, The Secured Creditor's Complaint: Relief from the Automatic Stays in Bankruptcy Proceedings, 65 CALIF. L. REV. 1216, 1222-23 (1977).} While a court might manipulate the stay to induce a secured creditor to take part de facto in the plan, there was no statutory basis for forcing an unwilling secured creditor to take part. Presumably one who waited out the stay had a right to the return of his collateral. There was no authority in Chapter XIII to cramdown, although a secured creditor could agree to a plan.\footnote{The treatment of secured claims under Chapter XIII varied widely among the various judicial districts. In part, this was due to the ambiguous language of the statute providing in section 646(2) that, a plan "may include provisions dealing with secured debts severally, upon any terms" while also in section 652(1) prohibiting confirmation of any plan until accepted in writing "by the secured creditors whose claims are dealt with by the plan." While some courts permitted slight modifications of secured creditors' rights, most found no cramdown authority. See 5 COLLIER ON BANKRUPTCY 1325.01[2][E][1] (rev. 15th ed. 1983); Countryman, Chapter XIII Wage Earners' Plans: Past, Present and Future, 18 CATH. U. L. REV. 275, 286 (1968); Poulos, The Secured Creditor in Wage Earner Proceedings: Dream versus Reality, 44 J. NAT'L CONF. REF. BANKR. 68, 69 (1970).}

Why does this power to "cramdown" diminish the creditor's rights? In effect, it deprives the secured creditor of that increment of value which inheres in the collateral because of the debtor's particular need for, or relation to, that collateral. In the crudest case, assume that the secured creditor has a secured interest in the debtor's hunting dog. The dog is a mongrel; it will have no value on the market. Presumably therefore, a plan probably could be approved under which the dog was given to the debtor without any payment whatsoever. That is so despite the fact that the debtor would pay a large sum to keep his hunting dog. Not only might he have an affection for the dog, but he may also have trained the dog to make it uniquely suited to his hunting habits. In effect, the dog has value to the debtor that it has to no other person. This same example can be played out, once removed, if one considers the debtor and his special relationship to his Corvette. Not only may he have a particular affection for this car, but he also knows its idiosyncracies, understands what the noise is when it hits 60 m.p.h., and appreciates the care he
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has taken of the automobile. For all these reasons, it may be worth more to him than it is to a third party. Yet the court in Chapter 13 will apply a bluebook value to that automobile, not the higher value the debtor is likely to ascribe to it. Going one step further, there are many similar cases in which a business debtor undergoing reorganization has a particular need for or knowledge of specific inventory or equipment. Because of that, the debtor would be willing to pay a substantially higher amount to retain that equipment than a third party would be willing to pay for it on the market. In all of these cases the probable effect of the cramdown is to deprive the secured creditor of that additional increment of value.

The second and equally important consequence of the cramdown authority is to expand the court's discretion and to allow the court to use it in ways that may be injurious to the creditor's interest. First, the court must determine the value of the collateral, and second, it must determine the value of the

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66 While some courts have recognized that assets such as automobiles may have value to the debtor higher than any measure of market value, they do not take that incremental subjective value into account when determining the value of the collateral and the concomitant amount of the allowed secured claim; at most the retail replacement cost is utilized. See Ford Motor Credit v. Miller (In re Miller), 6 Bankr. Ct. Dec. (CRR) 410, 412 (Bankr. S.D. Cal. 1980) (median between wholesale and retail replacement cost is appropriate valuation because it reflects the open market between private parties). Indeed, some courts appear determined not to take into account the debtor's special attachment to the asset. See GMAC v. Willis (In re Willis), 6 Bankr. Ct. Dec. (CRR) 1101, 1109 (Bankr. N.D. Ill. 1980) (average trade-in value is generally appropriate valuation for automobiles because it reflects what a reasonably willing buyer not under compulsion to buy would pay to a reasonably willing seller not under duress to sell). In Willis, the auto in question had been purchased only two weeks prior to the filing of the petition; therefore, the court refused to apply the general evaluation standard because it believed the original contract price constituted better evidence of what a willing buyer would pay and a willing seller would accept. Id. One measure of valuation used by several courts is the amount that could be realized upon disposition in a commercially reasonable manner, sometimes taking special notice of the creditor's business or usual means of collateral disposal. See Savloff v. Continental Bank (In re Savloff), 6 Bankr. Ct. Dec. (CRR) 349, 350 (Bankr. E.D. Pa. 1980); Virginia Nat'l Bank v. Jones (In re Jones), 6 Bankr. Ct. Dec. (CRR) 965, 967 (Bankr. E.D. Va. 1980); In re Adams, 5 Bankr. Ct. Dec. (CRR) 1234, 1235 (Bankr. M.D. Fla. 1980). In an effort to keep things administratively manageable, some courts simply use the bluebook wholesale value. See In re Crockett, 6 Bankr. Ct. Dec. (CRR) 226, 227 (Bankr. E.D. Ill. 1980); In re Adams, 5 Bankr. Ct. Dec. (CRR) 1234, 1235 (Bankr. M.D. Fla. 1980). See also 11 U.S.C. § 1325(a)(5)(B) (Supp. V 1981).
periodic payments typically given to replace the collateral. The appellate courts are likely to show little interest in redressing factual errors in determining value of collateral or present value of a stream of payments. Thus, one can assume that secured creditors will be made to live with the judgment of the bankruptcy trial judge.

In passing one should consider the argument that can be made to suggest that cramdown power is really no change. Because secured creditors were always willing to negotiate in such circumstances, is there no change? I think not. Formerly a Chapter XI secured creditor could threaten to take his collateral and go home once the stay was lifted. Under the current system, that will be a hollow threat because the debtor in possession can use the cramdown. By substantially changing the likely legal outcome on failure of negotiation, the enactment of these expansive cramdown rules reorders the negotiating power of the parties. Moreover, in the consumer context, section 524's restrictions on reaffirmation back up the cramdown rules.

In summary, the consequences of the various cramdown rules are to grant the bankruptcy court jurisdiction and discretion to determine the value not only of the collateral but also of the future payments, second, to deprive the secured creditor of the "personal" increment of value ascribed by the debtor to the collateral, and in sum, substantially to reallocate the negotiating power among the parties.

D. Avoidance Powers

Reading the cases and talking with those actively involved in bankruptcy practice, one concludes that the avoidance powers are far less significant than provisions such as the cramdown and the automatic stay. Nevertheless, the trustee's avoidance powers have been expanded by the Code in a number of respects. For instance, section 547 on preferences removes the requirement that the trustee prove that the creditor who received a preference had reasonable cause to believe the debtor to be insolvent. Further, the Code provides a presumption of insolvency during
the ninety days prior to the filing of the petition. In addition, it subjects "insider" preferences to attack even though they occurred as long as one year before the petition was filed. Section 547 also explicitly provides for attacking after-acquired property in a way that did not previously exist. The only concessions to the secured creditor are the codification of certain common law exceptions to preferences and the substitution of a ninety-day rule for the four-month rule of the Bankruptcy Act of 1898.

The net consequence of these changes is enhancement of the power of the trustee to set aside transfers. Under current law, the trustee will never lose a suit because he is unable to prove that the creditor who received a transfer lacked a reasonable cause for believing the debtor insolvent or that the debtor was insolvent at the time of the transfer. Now the creditor bears the burden of proving the debtor not insolvent.

Other provisions will have a modest, though perhaps significant effect on certain kinds of secured creditors. Section 544(a)(3) now allows the trustee to set aside unrecorded real estate mortgages that he could not attack under the law of many states prior to the Code.

Finally, section 522(f)(2) voids nonpurchase money nonpossessory security interests in certain consumer goods. Thus, the

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68 Bankruptcy Reform Act of 1978, §§ 547(c)(15), 547(e), 11 U.S.C. §§ 547(c)(5), 547(e) (Supp. V 1981). This paragraph codifies the "improvement in position" test, thereby overruling decisions such as DuBay v. Williams, 417 F.2d 1277 (9th Cir. 1969), and Grain Merchants of Indiana, Inc. v. Union Bank & Sav. Co., 408 F.2d 209 (7th Cir.), cert. denied, 396 U.S. 827 (1969). Thus if a secured creditor improves his position by acquiring a lien on additional after-acquired receivables and inventory during the ninety days preceding bankruptcy while making no new matching advance, there is a voidable preference to the extent that the security interest increased in value.

Notwithstanding any waiver of exemptions, the debtor may avoid the fixing of a lien on an interest of the debtor in property to the extent that such lien impairs an exemption to which the debtor would have been entitled under
classical security interest taken by the small loan company in the debtor's furniture and other household goods, which is neither possessory nor a purchase money security interest, is set aside by section 522.

E. Reach of the Bankruptcy Courts

If one accepts the view that bankruptcy courts are generally less sympathetic to secured creditors' claims than state courts, one finds an independent and significant injury to the secured creditor's interest simply because the secured creditor is now more likely than in the past to find himself before the bankruptcy court. Are the bankruptcy courts more hostile to secured creditors' interests than are the state courts? For a variety of reasons that is a plausible hypothesis. Not only will a bankruptcy judge be armed with the avoidance powers discussed above, he will also be more familiar than a state court judge with the various potential defects in the secured creditors' claims.

Unlike the state court judge who must simply determine the narrow dispute before him, the bankruptcy judge is directed to find a way to reorganize the debtor or to make a plan under which the debtor can pay off some significant part of his debts.

subsection (b) of this section, if such lien is —
(1) a judicial lien; or
(2) a nonpossessorv, nonpurchase-money security interest in any —
(A) household furnishings, household goods, wearing apparel, appliances, books, animals, crops, musical instruments, or jewelry that are held primarily for the personal, family, or household use of the debtor or a dependent of the debtor;
(B) implements, professional books, or tools, of the trade of the debtor or the trade of a dependent of the debtor; or
(C) professionally prescribed health aids for the debtor or a dependent of the debtor.

A highly unscientific sampling of the opinions of creditors' lawyers tells me that secured creditors view the bankruptcy court as a more hostile forum than state courts. Partly this is because of the specific avoidance powers and because of the powers such as the automatic stay. An articulate spokesman for this view is Paul Festerson. In his article, *Equitable Powers in Bankruptcy Rehabilitation: Protection of the Debtor and the Doomsday Principle*, 5 CREIGHTON L. REV. 221, 226 (1972), Festerson argues that the courts of bankruptcy have asserted or will assert whatever power is necessary to be exercised in an "altogether discretionary" way to achieve the goals deemed by them to be appropriate.

See 28 U.S.C. § 1471 (Supp. V 1981); see also Waxman, *A Solution to the Bank-
If he is true to that mission, he will often come in conflict with the secured creditors' interest, for the typical secured creditor will seek to deprive the estate of assets that may be critical to the reorganization. Finally, there may be deeper reasons, buried in the mode of selection of bankruptcy judges, that bring persons to the bankruptcy bench who initially are more sympathetic to the debtor's plight than are state court judges.

To some extent, Congress itself has given credence to the view that the bankruptcy courts are more generous than state courts. For example, in the 1970 amendments to sections 14 and 17 of the Bankruptcy Act of 1898, the Congress required that certain objections to discharge be presented in the bankruptcy courts, not in the state courts. Likewise, the enactment of the elaborate and difficult reaffirmation ritual in section 524 presumably is based in part on the assumption that the bankruptcy judge will be solicitous of the debtor's interests.

There are two unrelated reasons why a secured creditor is more likely to find himself before a bankruptcy judge under the Code than formerly was the case. The most obvious is the expansion of jurisdiction granting the bankruptcy court jurisdiction over all matters "arising in or related to" Title 11 cases and over all property of the estate "wherever located." Previously, jurisdiction had been restricted to the core bankruptcy functions such as litigation to recover the debtor's assets and had not been extended to such traditionally state law matters as property damage or breach of contract. Moreover, personal jurisdic-


64 The 1970 addition of § 17(c)(2), together with an amended § 14(f), provided that a creditor objecting to a discharge under § 17(a)(2) (false pretenses, false representations, false financial statements, and willful and malicious conversion), § 17(a)(4) (fraud or defalcation by an officer or a fiduciary), or § 17(a)(8) (other willful and malicious injuries to person or property) must raise his objections in bankruptcy court within the time fixed by the court; if he failed to raise the specified objections in that forum, he was not permitted to do so elsewhere. For criticism of the draftsmanship of the 1970 amendments, see Countryman, The New Discharge-ability Law, 45 AM. BANKR. L.J. 1, 25-27 (1971).


68 The legislative history of the statute expressly states that under the Bankruptcy
tion under the Bankruptcy Act was essentially limited to actions in rem and actions in which the defendant had consented to the bankruptcy court's jurisdiction. Putting aside the issues raised in *Northern Pipeline Construction Co. v. Marathon Pipeline Co.*, any claim by the trustee to collateral, wherever located, could now be asserted in the bankruptcy court rather than through a private action in a state court. Assuming that the *Marathon* dispute ultimately is resolved in a way consistent with the drafters' intent, adversary proceedings of all kinds will be heard before the bankruptcy court, not in state court as formerly would be the case.


"See 1 Collier on Bankruptcy ¶ 3.01[2][a] (rev. 15th ed. 1983). When property was in the actual or constructive possession of a third person asserting a bona fide adverse claim, the bankruptcy court had no jurisdiction to summarily determine that person's claim without his consent. See 6 Collier on Bankruptcy ¶ 3.05 (rev. 14th ed. 1978). Illustrative of this state of affairs is the secured creditor holding repossessed property as a result of the exercise of self-help enforcement. The case law under the Bankruptcy Code generally deals with these circumstances by finding the secured creditor to be a "custodian" within the meaning of 11 U.S.C. § 101(10)(c) (Supp. V 1981) and thus required to return the property to the estate pursuant to 11 U.S.C. § 543 (Supp. V 1981). See ABD Fed. Credit Union v. Williams (*In re Williams*), 6 Bankr. Ct. Dec. (CRR) 1219, 1220 (Bankr. E.D. Mich. 1980). But see Flournoy v. City Fin. Inc., 679 F.2d 821, 822-24 (11th Cir. 1982). In any case, the mere presence of a third party holding under an adverse claim of right no longer deprives the court of jurisdiction on that basis alone.

"See supra note 68; see also H.R. Rep. No. 595, 95th Cong., 1st Sess. 445, reprinted in 1978 U.S. Code Cong. & Ad. News 5963, 6400 ("Actions that formerly had to be tried in State court or in Federal district court, at great expense and delay to the estate may now be tried in the bankruptcy courts.")
The second and unrelated reason for the secured creditor to find itself before the bankruptcy court concerns the many provisions of the Code that now make bankruptcy more palatable both to consumers and to business. For example, the expansion of exemptions in section 522 and the capacity to be discharged from virtually all debts of whatever nature under Chapter 13 now make bankruptcy a suitable alternative for many for whom it would not have been acceptable prior to the Code. Likewise, the cramdown provisions, the stay, and the fact that claims (however contingent) can be resolved in bankruptcy, may bring business debtors to court who formerly would have contented themselves with private negotiations.\textsuperscript{73} The radical increase of

\textsuperscript{73} A quick examination of the discharge provisions of Chapter 13 and of the exemption provisions in § 522 shows why individuals who might not have declared bankruptcy prior to the Code may now do so. It is much less obvious why the same might be true of businesses. Doubtless, some businesses will choose Chapter 11 today who previously would not have chosen either Chapter XI or Chapter X because of the expanded powers that are given to the debtor in possession.

There is another class of business debtors that may find it desirable to file in Chapter 11 under the Code and who would not have done so under the prior law. These are debtors whose principal creditors are plaintiffs and potential plaintiffs in mass tort law suits. A current and notorious example of this class is the Johns-Manville Corporation, which filed a Chapter 11 petition in the Southern District of New York in 1982. See, e.g., Johns-Manville Corp. v. Doan (\textit{In re} Johns-Manville Corp.), 7 Collier Bankr. Cas. (MB) 1231 (Bankr. S.D.N.Y. 1983); Johns-Manville Corp. v. Doan (\textit{In re} Johns-Manville Corp.), 26 Bankr. 919 (Bankr. S.D.N.Y. 1983) (earlier opinion in same case on related matters); Johns-Manville Corp. v. Asbestos Litigation Group (\textit{In re} Johns-Manville Corp.), 26 Bankr. 420 (Bankr. S.D.N.Y. 1983) (same). \textit{Johns-Manville} is but the most prominent of these cases. See, e.g., \textit{In re} Related Asbestos Cases, 23 Bankr. 523 (N.D. Cal. 1982); \textit{In re} UNR Industries, Inc., 23 Bankr. 144 (Bankr. N.D. Ill. 1982). In addition, the potential exists for a similar result in a variety of other cases where corporate defendants are confronted with a large number of tort plaintiffs. None of these cases would have found their way into the bankruptcy court under the old law.

Under the Bankruptcy Act of 1898 (as it existed in 1978) only provable and allowable claims were discharged. Certain claims, such as those arising out of intentional torts, could not be proved and therefore were not discharged. Negligence claims could be "proved" only if the debtor had been sued on the claims before the bankruptcy proceedings were initiated. Even if the claim was provable, it was not allowable if it could not be liquidated or reasonably estimated, or if that estimation would unduly delay the administration of the estate. Thus, under the Bankruptcy Act it was unlikely that a defendant could escape liability even to plaintiffs who had filed suit; it was impossible that he would escape liability to potential litigants.

Under the Code, Congress dispensed with the concept of provability. Moreover, it directed the court to fix the value of all contingent and unliquidated claims, regardless of their capacity for reasonable estimation. Thus, it became not a matter of discretion with
consumer bankruptcies over the last several years is partly attributable to the recession. A large part of that increase, however, must also be attributable to the new provisions that make bankruptcy more palatable.74

The combination of these events, expanded jurisdiction, and the increased willingness of those to go into bankruptcy, means that the secured creditor will now find itself more often than before in front of a judge that is armed with avoidance power, with the knowledge of creditors' foibles, with the directions to foster reorganizations and protect debtors, and conceivably with an anti-creditor bias.

F. Fraudulent Conveyance and Foreclosure Sales

One of the events that has large potential for diminishing secured creditor rights rises from the cases, not from rules or the bankruptcy court, but a matter of obligation to estimate such claims.

In circumstances such as existed in Johns-Manville, courts ultimately may refuse to deal with most such claims. In the first place, courts may find that the more remote claimants (those who have not filed suit and those who may have been exposed to asbestos but show no symptoms of illness) are not yet "claimants," and thus are untouched by the bankruptcy proceedings. Particularly with respect to those whose claims are remote, there are important due process questions about whether one should permit one's rights to be extinguished at a time when one may be ignorant of those rights. For a discussion of some of the questions associated with estimating such claims, see Note, Procedures for Estimating Contingent or Unliquidated Claims in Bankruptcy, 35 Stan. L. Rev. 153 (1982).

74 In the twelve month period ending June 30, 1981, the first full statistical year under the Bankruptcy Code, a total of 360,329 cases representing 518,152 estates were commenced in bankruptcy courts. This was the largest number of bankruptcy estates ever filed in one year and a 43.8% increase over the previous record high set in 1980. Business bankruptcies also increased but remained in the same ratio to former total estates. See 1981 Annual Report of the Administrative Office of the United States Courts 131-36. Using a regression model, one commentator calculates that the new Bankruptcy Code may be directly responsible for as much as a third of the increase in personal bankruptcy filings. See Kowalewski, Personal Bankruptcy: Theory and Evidence, Fed. Reserve Bank of Cleveland Econ. Rev. 1 (Spring 1982); see also Bankruptcy Reform Act of 1978: Hearings Before the Subcomm. on Courts of the Comm. on the Judiciary, 97th Cong., 1st Sess. 13 (1981) (statement of Arthur F. Brimmer, President, Brimmer & Co., Economic and Financial Consultants); Evans & Johnson, Proposals for Consumer Bankruptcy Reform, 37 Bus. Law. 1117 (1982); Martin, Creditor Alternatives to Obtain Relief from Automatic Stays in Bankruptcy, 87 Com. L.J. 22, 22 (1982). But cf. Petzinger, A Bankruptcy Boom, 2 Cal. Law. 32, 36 (1982) (describing reluctance of businesses to file for bankruptcy even when it is their only hope).
statutes. In *Durrett v. Washington National Insurance Co.*, the Fifth Circuit applied the law of fraudulent conveyances in a novel and potentially damaging way to foreclosure sales. In that case, the trial court found the fair market value of the collateral to be $200,000. Neither party challenged that finding on appeal, but the trustee argued that the foreclosure sale for $115,400 (57.7% of the fair market value) was not "the fair equivalent" for the transfer of that property. Consequently, he maintained that it was voidable under section 67 of the Bankruptcy Act. Agreeing with that argument, the court suggested that anything less than 70% of the fair market value would not be the fair equivalent. That case has been followed in a subsequent Fifth Circuit opinion, *Abramson v. Lakewood Bank & Trust Co.*, over the dissent of Judge Clark. It has been explicitly rejected by the bankruptcy panel for the Ninth Circuit in *Lawyers Title Insurance Corp. v. Madrid (In re Madrid)*, and by several other courts.

Note first that *Durrett* can be applied just as readily under the Code as under the Act of 1898. The important language in section 67(b) appears now in section 548. Indeed, it may be easier to reach the result under the Code. Moreover, there is noth-

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76 621 F.2d 201 (5th Cir. 1980).
77 21 Bankr. 424 (Bankr. 9th Cir. 1982).
ing that necessarily restricts *Durrett* to real estate foreclosures; it would be just as easy to reach that result in the resale of an asset under Article 9. If *Durrett* is generally accepted, nearly all sales of repossessed collateral will be subject to attack under section 548 if the debtor goes into bankruptcy within one year of the sale. The trustee may be able to reach back beyond one year by using section 544 and subrogating himself to one who would have a claim under the state fraudulent conveyance law.

As Judge Clark points out in his dissent in *Abramson*, the likely result of such a rule is to cause those who bid at foreclosure sales to reduce their bids by some increment equal to the probability that the debtor will go into bankruptcy and that some trustee will make the buyer disgorge the property.

To the creditor such a consequence will mean that he will place less reliance upon his collateral for two reasons. First, he will expect to receive less on foreclosure than he would have otherwise, because others will discount the price. Second, he can expect to be embroiled in further litigation with the disappointed buyer if the foreclosure sale is upset. The cases to date do not elaborate the potential liability that the secured creditor might have in such circumstances.80 In these instances it is conceivable that the secured creditor will give an express or implied warranty of title. Thus, it is possible that the disappointed buyer would come back to the secured creditor and would insist that the secured creditor take his position and pursue the claim in the bankruptcy estate.

One can hope that the view of the bankruptcy panel for the

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80 Thus far, courts have focused on the rights of the trustee or debtor in possession to recover the property transferred pursuant to § 550(a) and the rights of the disappointed buyer under § 548(c) and § 550(d) to a lien on the property transferred at least equal to the foreclosure price. They have not considered whether a disappointed buyer may, in addition to or in lieu of enforcing the § 548(c) lien, impose liability on the secured creditor for whose benefit the foreclosure occurred. See Gillman v. Preston Family Inv. Co. (*In re Richardson*), 23 Bankr. 434, 448-49 (Bankr. D. Utah 1982); Coleman v. Home Sav. Ass'n (*In re Coleman*), 21 Bankr. 832, 836-37 (Bankr. S.D. Tex. 1982); Smith v. American Consumer Fin. Corp. (*In re Smith*), 21 Bankr. 345, 352 (Bankr. M.D. Fla. 1982); Home Life Ins. Co. v. Jones (*In re Jones*), 20 Bankr. 988, 994-96 (Bankr. E.D. Pa. 1982).
Ninth Circuit will prevail. It is far better to attack inappropriate and unfair foreclosures frontally by asserting (a'la U.C.C. section 9-504) that they are not "commercially reasonable" than by coming in the back door. The Durrett approach introduces unnecessary uncertainty; by granting some unidentified court authority to find the sale price was less than 70% of the "value," it casts a cloud over virtually every foreclosure proceeding. At this writing, there are two decisions by one court of appeals asserting this idea; no other courts of equal status have addressed it.81

II. CREDITOR RESPONSES

A. Introduction

If this combination of rules, cases, and the enactment of the Bankruptcy Reform Act of 1978 has significantly reduced creditors' rights, one can be certain that creditors and their lawyers are busy with schemes to recoup their losses. The nature of creditor responses are important for a variety of reasons. They are important to everyone actively involved in bankruptcy practice, for they will tell us whether the rules that have been established, as discussed above, will in fact apply or whether they will be circumvented by the creditors' actions. They are important for the economists because they will give some insight on the grand question whether security is sufficient; they may also instruct on a narrower question—whether the changes wrought by the Code will produce a more efficient system than previously existed. For similar reasons, the creditor responses are important to legislators, for only by assessing them can the legislator determine whether the goal of greater equity and fairness has been achieved and at what cost. Most significantly, the efficiency of these responses are important to the creditors themselves. Secured creditors ultimately may conclude that attempting to gain security, or something like it, is so difficult and inefficient that they may as well become unsecured creditors.

81 Aside from the Madrid decision, all courts that have considered and rejected Durrett's seventy percent rule have been bankruptcy courts. See supra notes 76-77 and accompanying text.
One can easily visualize at least six creditor responses to the events described in Part I of this paper. I do not argue that this is an exclusive list; I am confident that it is not. Most of the devices discussed below are now in use as security substitutes. I suggest only that their use will become more widespread. History tells us, however, that one should not underestimate the creditors' imagination. Surely they will devise modes of operation more intricate and elegant than any law professor could conceive. Only time will reveal those to us; for now, consider six possible responses.

First is the creditor's retention of ownership of assets that might otherwise belong to the debtor. Examples are leasing and consignment. Second is the possibility of the creditor's purchase of assets from the debtor, classical factoring and perhaps more. Third, one can expect the creditor to take a broader security interest than before. Fourth, many creditors will insist upon a guaranty in circumstances where one might not have been required before. Fifth, a combination of debtors and creditors may attempt to allocate part of the cost to the taxpayers in the form of government guarantees. Finally, secured creditors are likely to charge higher rates in an attempt to offset the cost imposed by their inability to enjoy the full value of their collateral.

B. Lease and Consignments

Leasing and consignments are two forms of purchase money financing with a long history in the law of creditors' rights. For many reasons creditors have often written security agreements in the form of leases. If one writes this contract as a "true lease" was to assure that the "lessee" would get a deduction as a business expense for the full amount of his payment. If he were treated as a purchaser under the federal income tax law, the lessee would have been entitled to a depreciation deduction; that deduction was often not as large as the full amount of the payment. Second, the debtor sometimes may wish to lease rather than buy to avoid showing a liability on its balance sheet. Third, a buyer may be prohibited from certain types of borrowing by agreements made as part of earlier loans. In some circumstances, additional borrowing as a part of a "purchase" transaction will violate these provisions, but a "lease" of the same asset will not. Finally, there also may be state tax considerations for leasing. Note that the Uniform Commercial Code has accommodated to this problem by permitting those who wish to characterize their transactions as leases nevertheless to file under § 9-408.

**The initial reason, which may still have vitality, for writing a transaction as a lease was to assure that the "lessee" would get a deduction as a business expense for the full amount of his payment. If he were treated as a purchaser under the federal income tax law, the lessee would have been entitled to a depreciation deduction; that deduction was often not as large as the full amount of the payment. Second, the debtor sometimes may wish to lease rather than buy to avoid showing a liability on its balance sheet. Third, a buyer may be prohibited from certain types of borrowing by agreements made as part of earlier loans. In some circumstances, additional borrowing as a part of a "purchase" transaction will violate these provisions, but a "lease" of the same asset will not. Finally, there also may be state tax considerations for leasing. Note that the Uniform Commercial Code has accommodated to this problem by permitting those who wish to characterize their transactions as leases nevertheless to file under § 9-408.**
lease,” the legal rules that apply to it are unambiguous under the Bankruptcy Code, under Article 9 of the UCC, and under the common law of the various states. The same is not true of a consignment. The Uniform Commercial Code inartfully deals with consignment. It is not clear, to me at least, that one can write a consignment that will not be treated as a security agreement under Article 9. This uncertainty under the UCC is certain to spawn additional uncertainty for the consignor under the Code.

Turning first to the lease, what happens if the creditor chooses to characterize himself as a lessor and to write his agreement as a true lease? Both the Uniform Commercial Code and the Code recognize him as such. Under the Uniform Commercial Code, a true lease is outside of Article 9; it simply constitutes a contract with respect to goods, and it is enforceable according to the common law of bailment of the particular state. Under the Code, a lease typically would be treated under section 365, the provision dealing with executory contracts and leases.

Upon the bankruptcy of the lessee, the lessee and his trustee have two options. If they decide to reject the lease, they must forfeit the goods to the lessor, who takes the goods and may assert certain limited rights against the bankrupt estate as an unsecured creditor. Note, however, there is no option or discretion on the part of the trustee to argue that the asset is worth less than the lessor believes it to be worth, and thus, it may be retained in a plan for payment equal to something less than the lease payments. If the trustee or the debtor instead chooses to assume the lease, he has the responsibility of curing any existing default, and then must comply with the lease, term by term. The full amount of the payments provided for in the lease must be made, and they must be made under the same schedule as provided in the lease. To repeat, the court has no option such as exists under section 1129 to conclude that the leased goods have a value less than that represented by the payments provided under the lease, and thus, to authorize lower payments or the

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same payments over a longer term.

In view of these provisions and the recognition of the lessor's right as an owner, some have suggested that those who formerly would have cast their transaction as a security interest might now wish to write it as a true lease. In most circumstances, a true lease cannot have exactly the same economic consequences and risks as a security agreement. In the classical lease, the lessor assumes the risk that the leased goods will depreciate more rapidly than he contemplates at the outset; on the other hand, the lessor also enjoys the benefit that arises from appreciation in the leased goods. In a sale and security agreement both the risk and benefit rest with the debtor. Typical documents in current use as "leases" have some of the attributes of a classical lease and some of the attributes of a standard security agreement. Should the lease be written for the entire useful life of the collateral, or should it provide that the risk of excessive depreciation rests with the debtor, the lessor runs the risk of having a court conclude that the "lease" is in fact a security agreement. Thus to enjoy the benefits of section 365, the

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85 If the lease is determined to grant a security interest that has not been perfected, the creditor-would-be-lessor clearly loses to the trustee. Unfortunately, it is difficult to be certain that a lease will not be held a security agreement because that is to be determined by the facts of each case. U.C.C. § 1-201(37) (1972). When, at the end of the lease term, the lessee gets the asset for no additional consideration, or at only token consideration such as one or two dollars, the lease will be held a security agreement. See, e.g., Bolen v. Mid Continent Refrigerator Co., 411 N.E.2d 1255, 1258 (Ind. Ct. App. 1980) (lessee could receive title to refrigerator for $1 and sales tax; held security interest). The mere presence or absence, however, of an option to purchase is not determinative whether the device is held a lease or security interest. See, e.g., In re Tillery, 571 F.2d 1361, 1366 (5th Cir. 1978) (absence of purchase option not an obstacle to finding security interest); In re Winston Mills, 6 Bankr. 587, 597 (Bankr. S.D.N.Y. 1980) (parties' intent to be determined from economic substance of their agreement); Adelman v. GMAC (In re Tulsa Port Warehouse Co.), 4 Bankr. 901, 905 (Bankr. N.D. Okla. 1980) (substance considered over form to decide whether agreement constitutes lease or security interest); Van Alphen v. Robinson, 420 N.Y.S.2d 44, 46 (1979) (presence of purchase option does not preclude device from being a lease).

In general, courts have tended to employ some form of an "economic realities" test whereby a purported lease will be held a security interest if the only sensible business decision at the end of the lease term would be to acquire the asset in question. See, e.g., Percival Constr. Co. v. Miller & Miller Auctioneers, Inc., 532 F.2d 166, 172 (10th Cir. 1976) (purchasing as lessee's only viable business choice); Citicorp Leasing v. Allied In-
creditor may have to give up certain protections and accept certain risks that would not have been imposed upon him, at least under the pre-Code bankruptcy law.

Arguably, section 2-326 is a substantive rule of law that assigns certain rights to the parties in any consignment transaction. Specifically, section 2-326(2) provides, "goods held on sale or return [i.e., on consignment] are subject to such [buyers', creditors'] claims while in the buyers' possession." The section provides that the consignor can buy protection against such creditors by filing a financing statement. Section 9-114 of the 1972 amendments elaborates on those rights. That section contemplates that certain consignments are "intended as security" and others are not. Section 1-201(37), dealing with security interests, specifies that even consignments not intended as "security interests" are subject to the provisions under section 2-326.

The combination of these sections leaves considerable uncertainty. Conceivably, section 2-326 is stating that, irrespective of the parties' intent or the language of their agreement, the consignee's creditors will have rights in the collateral superior to those of the consignor unless there is a filing. In short, one can read section 2-326 as a rule of substantive law to the effect that any consignment is the conveyance of a property interest to the consignee sufficient to give an interest in his creditors superior to that of the consignor. 87 Note, this is in marked contrast to the Uniform Commercial Code's application to true leases; it leaves such questions to the common law of the state, which would find the interest of the lessee's creditors subordinate to the lessor's interest. On the other hand, one may read the references to consignments "intended as security" to mean that a carefully constructed consignment gives the consignee and his creditors no greater rights than a lessee would have.

Under Article 9, if the consignor files a financing statement, all of this is academic. By filing he gains superiority over other

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competitors. In bankruptcy, however, it is not academic. If we treat the consignor merely as a secured creditor in bankruptcy, he will then be subject to cramdowns under sections 1325 and 1129 of the Code. On the other hand, if we treat him as the true owner of the property, subject only to a contract, there will be no possibility of a cramdown and the debtor in possession will obtain rights to the collateral only by adopting the contract under section 365 of the Code and living up to all of its terms.

Presumably, the different treatment of consignments and leases under the UCC is attributable in part to the fact that consignments were already a well-developed mode of financing at the time the UCC was enacted, whereas leasing was not as widely recognized as a financing substitute. Perhaps more important, the expectation of a competing creditor who sees goods, apparently part of inventory but in fact on consignment, is different from the expectation of the creditor who sees goods in use as equipment, and apparently on lease. Presumably, the former has greater potential for misleading creditors than the latter. If any possible misperception by competing creditors has been solved by a public filing under Article 9, what is the basis in bankruptcy for giving one treatment to consignments and another to leases? I am uncertain that there is any. By hypothesis both of these transactions are analogues to secured loans. If one is treated more favorably than the other in bankruptcy, one can expect creditors to adopt the more favorable mode.

It is possible that the differential treatment provided under sections 1129 and 1325 cramdowns on the one hand, and under section 365 (no cramdown) on the other, will send creditors scurrying for section 365 treatment. Doubtless this will produce a new crop of cases on that tedious question: is this document a true lease or merely a disguised security agreement? It will also bring litigation on the status of consignments in bankruptcy,

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88 Equipment leasing is now so widespread that it is unlikely any sensible creditor relies upon his debtor's possession of equipment as proof of ownership without first making some inquiries concerning the extent of the debtor's ownership interest. Although consignment has become more common, and it may sometimes be possible to charge a creditor with knowledge of the consignment, the potential for being misled by appearances is still greater than in equipment leasing. See R. Spredel, R. Summers & J. White, Commercial and Consumer Law 254-57 (3d ed. 1981).
and it may stimulate the imagination of creditors' lawyers to devise forms of ownership that are not leases, nor consignments, nor security agreements.

C. Purchasing Assets of the Debtor, Factoring

A second proposal that has recently been made to deprive the bankruptcy court of jurisdiction and to free assets from the automatic stay is to adopt the ancient practice of factoring. Under a classical factoring arrangement, the creditor purchases accounts receivable without recourse, takes possession of all the documents, and makes collection directly from the account debtors. If he does all of those acts and files a financing statement as well, he has probably escaped the jurisdiction of the bankruptcy court. He has avoided any possibility that the trustee in bankruptcy will be able to enjoy any appreciation in the value of the collateral, and he has freed himself from the stay in section 362.

Attempts at factoring that preserve some elements of recourse against the debtor are certain to face challenges by debtors in possession and by trustees. To the extent that the purchaser of accounts receivable retains a recourse right against the debtor, the transaction takes on more of the colors of a loan and less those of an outright purchase of specific assets. If factoring is widely adopted in an attempt to avoid the automatic stay and cramdown, we will see litigation about what "loan" elements can be present in a factoring agreement and yet have it qualify as a true factoring arrangement.

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** See Koch, Bankruptcy Planning for the Secured Lender, 99 BANKING L.J. 788, 792-96 (1982); cf. Major's Furniture Mart v. Castle Credit Corp., 602 F.2d 538, 540 (3d Cir. 1979) (court will look behind language of transaction to decide whether legal rights and economic consequences of agreement are more like those of a sale or a financing transaction).

** A court will have to consider whether an agreement is a true sale of accounts or only a secured loan, a problem not unlike that faced with purported leases. Conceivably, a court may rule that an assignor's retention of some legal or equitable interest in the assigned accounts makes the transaction a secured loan. See, e.g., Major's Furniture Mart v. Castle Credit Corp., 602 F.2d 538 (3d Cir. 1979) (transfer of customer receivables by debtor found to be financing transaction); Credit Alliance Corp. v. Nixon Machinery Co. (In re Nixon Machinery Co.), 6 Bankr. 847, 851 (Bankr. E.D. Tenn. 1990) (assignment of accounts with recourse declared security transaction); see also 11 U.S.C. § 541(d) (Supp. III 1979) and infra note 91.
There will also be litigation about application of the stay in certain circumstances where the disposal of the account is not complete. Assume, for example, that a creditor purchases accounts receivable and has no recourse against the debtor, but he does not notify the account debtors. Assume that he executes an agreement with the debtor to collect the accounts on his behalf. Under this arrangement, presumably the debtor continues to collect the accounts and periodically pays the proceeds over to the creditor. Will the automatic stay prohibit such payment? It would seem so. In that circumstance, will the automatic stay prohibit the creditor from himself notifying the account debtors and making collections after the petition? That is less clear.91

Assuming that Congress has the constitutional power to do so,92 it seems highly unlikely that Congress has the will to enact

91 Section 541(d) of the Bankruptcy Code arguably addresses this point and renders the factored accounts not part of the estate. See 11 U.S.C. § 541(d) (Supp. III 1979). By that section, Congress intended to permit a mortgagee to sell shares of his mortgages to third parties and continue to service them. It is intended to grant the purchasers of such mortgage interests priority over the trustee in bankruptcy of the seller. The case is precisely analogous to the one posed in the text. Although subsection (d) was stimulated by the mortgage question, the language of the subsection would apply to other factoring arrangements as well.

92 Congressional response to widespread factoring and leasing might take various forms. Initially, Congress might simply amend § 365 to provide for the treatment of leases under § 1129. Conceivably, Congress could enact a law that would purport to override contrary state rules. Such a law might provide that at least in bankruptcy, transactions framed as “factoring” or “leases” under state law be regarded as security transactions. If such a law applied only to transactions entered into after its effective date, it would merely constitute a federal redefinition of the property rights of the persons who entered into those transactions.

Consider some of the constitutional objections that would certainly be asserted if Congress retroactively attempted to change the rights of lessors and factors. The most obvious challenge is one under the taking clause of the 5th Amendment. Justice Rehnquist's opinion in United States v. Security Industrial Bank, 103 S. Ct. 407 (1982) suggests that at least the conservative wing of the Supreme Court would be receptive to such arguments.

Note that if the legislation were cast in the form, not of redefining the private property rights that attach to a certain status, but rather that of redefining the form necessary to achieve that status, the challenge would be more difficult. For example, Congress might enact an amendment to the Bankruptcy Code that would state that a lease or factoring transaction would have to have certain attributes in order to be recognized as a true factoring agreement under the Bankruptcy Code. Even though it might be virtually impossible to achieve that status, the Congressional subterfuge would make the challenge much more difficult. A similar challenge might be based on the due process clause of the 5th Amendment. Even if Congress were quite unsubtle and simply purported to make a
legislation to deprive the creditor of the power either of exercising a lessor's rights under the section above or of factoring, as provided in the previous paragraphs. To prohibit those transactions would require legislation that not only changes the substantive law concerning ownership interests, but also overrides the explicit agreement of the debtor and creditor. Surely Congress is unwilling to prohibit the debtor, even one on the verge of bankruptcy, from making good faith disposals of his property. Failing such a general prohibition, how could Congress prohibit such a debtor from selling his accounts to another creditor? I maintain that it would not do so. Moreover, Congress is unlikely to wish to call into question all transactions that occur during some short period prior to bankruptcy. To grant the bankruptcy court the power to upset all such transactions, including those...
for current consideration and in good faith, would merely accelerating the debtor's slide into bankruptcy, for the debtor would find no one willing to deal with him in the face of the slightest rumor of impending bankruptcy.

Conceivably, Congress could enact legislation that would do the same thing to a lessor's interest as arguably has been done to a consignor's interest by section 2-326. Congress, however, has not yet done so; sections 1129 and 365 fall well short of such action. Moreover, for Congress to do so would be a substantial intrusion into an area traditionally reserved to the states concerning the property rights of private parties.

In conclusion, it appears that factoring, leasing, and possibly consignment, can be used by secured creditors to avoid some of the more objectionable aspects of the cramdown, and possibly even of the automatic stay. Accordingly, we can expect to see an increase in their use and the rise of litigation concerning the legal rights of factors, lessors, and consignors in bankruptcy.

D. Taking Greater Security

An obvious response to any reduction in a secured creditor's rights is to take more security. One can expect, therefore, that the first secured creditor in line will ask for a security interest in a larger number of assets than he might have otherwise. If one assumes that all of the assets of a typical bankrupt are subject to some security interest at the time the petition is filed, the consequence of a first secured creditor taking a larger share simply will be to shift the loss from one party to another. Such a shift will not substantially change the position of the debtor, unless it means that other creditors will not lend at all when there are no assets to secure them. If that is so, the potential pool of creditors may become smaller than would otherwise be the case. That consequence is problematical.

E. Guaranties

Another obvious response to adversity on the part of secured creditors is to insist on guaranties. In the consumer context these are likely to be from family members; in the context of the small business they are likely to take the form of personal
guaranties by the principals. With larger businesses they are likely to be found in the guaranties of parent or subsidiary corporations.

Except in Chapter 13 cases, where section 1301 stays collection efforts against sureties of consumer debts, the filing of a petition by the principal does not stay collection efforts against guarantors.\textsuperscript{98} Thus, in Chapter 11 and Chapter 7 proceedings, one can expect secured creditors to turn to those who have guaranteed the debts.

\textbf{F. Higher Rates}

The fourth and most obvious response to reduction in a secured creditor's rights is likely to be an attempt to increase charges. At least in the business context, where usury laws do not limit the rates of charge, this is an obvious and almost certain response to a decline in the value of security. Conceivably such higher rates may be offset by lower rates on the part of unsecured creditors who may now enjoy a share of the assets that formerly would have gone to the secured creditors. That, of course, will not be true in the consumer context where the debtor himself may enjoy that element of value, as for example, when he buys the Corvette out of the estate for $8,000 instead of having to pay $15,000 to the secured creditor.

\textbf{G. Shifting the Risk to the Taxpayer; Guaranteed Loans and Other State Assistance}

Most of the responses discussed above are short-term and

\textsuperscript{98} Bankruptcy Reform Act of 1978, §§ 524(c), 1301, 11 U.S.C. §§ 524(c), 1301 (Supp. V 1981). See generally H. Miller & M. Cook, A Practical Guide to the Bankruptcy Reform Act 421-23 (1979). Testimony before the Commission on the Bankruptcy Laws of the United States indicated that creditors frequently required co-signatures on consumer loans by the debtor's friends or relatives who generally were unaware of the legal significance of their acts. In the belief that this practice unjustifiably deprived consumer debtors of the full benefit of their discharge and upon finding the problem particularly serious in Chapter XIII cases, the drafters of the Bankruptcy Code adopted a special automatic stay applicable in Chapter 13 to creditor efforts to collect consumer debts from individuals liable on a debt with the debtor. See 5 Collier on Bankruptcy ¶ 1301.01[1] (rev. 16th ed. 1983); P. Murphy, Creditors' Rights in Bankruptcy § 18.02 (1980); Kennedy, Automatic Stays Under the New Bankruptcy Law, 12 U. Mich. J. L. Ref. 3, 49-61 (1978).
individualistic. If creditors' rights are sufficiently impaired that creditors choose not to make certain loans, and further, if those loans are perceived by Congress to be of sufficient social value, we may expect to see new forms of federal loan guarantees of the kind that exist today. Currently there are over 160 federal loan guaranty programs. These are designed to benefit the veteran, home buyer, farmer, student, synthetic fuel manufacturer, car manufacturer, and even small airlines. For the same reason that private parties often improvidently grant guaranties, Congress itself has been willing to guarantee many forms of loans. At the outset a guaranty looks free — one simply puts his name behind another — and if everything goes as expected and planned, he is never called upon to pay a penny. Indeed, the guarantor may charge a fee for the use of his name and thus make money by giving his guaranty.

It is difficult to predict when and where Congress might be moved to guarantee new types of loans. The frequent enactment of such legislation, however, suggests that we have not seen the last loan that Congress will guarantee. One can visualize a scenario under which creditor responses would reduce the level of credit for certain kinds of activities below that deemed acceptable to Congress, and in which Congress would step in. Consider the following scenario. Assume, for example, credit unions, banks, and other traditional automobile lenders find that they cannot lend money profitably against automobiles in part because of the large number of bankruptcies in which the owners of automobiles retain the car, do not reaffirm, and discharge the debt by a payment much lower than the outstanding debt. Assume that these lenders cease making car loans and turn instead to treasury bills or business borrowers. Conceivably some who might be willing to make car loans find that they are unable to do so profitably because the usury limit prohibits them from acquiring a market rate. How might Congress respond to a pro-

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44 A more cynical analysis might lead one to ask whether those seeking loans have sufficient political influence.


46 A number of empirical studies have found that when the market rate of interest exceeds the usury limit, the result is a decrease in the amount of available credit. See
posal for federal guarantees? A Congressman voting for such loans could simultaneously court the automobile industry, the UAW, and hundreds of thousands of prospective car buyers. Moreover, a guaranty does not "cost" anything, and the whole program can be portrayed as cost-free.

The automobile scenario may be farfetched. It is not farfetched, however, to suggest the enactment of government guarantees in arenas now unforeseen where creditors have withdrawn and when Congress perceives a need.

CONCLUSION

In concluding, I apologize for the poverty of my imagination. Several of the suggestions about creditor behavior that I have made could have been devised by a first-year law student. Surely the creditor's lawyer will propose much more innovative and elegant devices than I have suggested here.

I apologize too, for not addressing what is the single most interesting question here; namely, whether society will be benefited by the net accommodations that will arise from the change in the law offset by the creditors' responses. It is conceivable that the methods adopted by the creditors as substitutes, such as leasing and factoring, will be less efficient means to accomplish the same goals as the taking and perfecting of a security interest in personal property.

If, as I suggest, Congress is moved to guarantee certain consumer and business loans, it seems inevitable that we will have produced an inefficient response. The recent history with the student loans has shown how horribly costly such a system can be.97 Although the abuses and difficulties have not been as obvi-


97 At least initially, in that system there was no significant motivation on the part of the universities to make collection. Default rates soared far above the rates that would have been experienced or tolerated by any private lender. See generally Hunter, Collecting Defaulted Student Loans: How Much Diligence is Due?, 9 J.C. & U.L. 149 (1982-83); Skipping Out on Alma Mater: Some Problems Involving the Collection of Student Loans, 15 COLUM. J.L. & SOC. PROBS. 317 (1980); Doyle, The Federal Student Loan Mess, Wall St. J., May 19, 1982, at 28, col. 4. According to the latest available figures, the default rate (number of loans in default as a percent of cumulative matured loans) for 1979 was 16 percent for National Direct Student Loans and 11.5 percent for Guaranteed
ous in other areas, one suspects that a careful examination of the Small Business Administration, or of a variety of the other guaranty programs, might reveal similar, if less dramatic, inefficiencies. Of course, that is not to say that Congress was wrong in establishing these programs. At least if there was no other more efficient method of accomplishing the Congressional goal, perhaps the cost was worth it.

If one considers the simplicity of acquiring and perfecting a security interest under Article 9, and notes how widely the Article 9 security interest has been accepted and applied, it seems unlikely that creditors regard factoring and other such ancient substitutes to be as efficient. If the enactment of the Bankruptcy Reform Act of 1978 and a series of other events occurring between 1965 and 1980 have substantially diminished the rights of personal property secured creditors, history tells us that those creditors will seek to regain their lost ground in a variety of ways. The principal consequence of the erosion of creditors' rights may be to drive creditors to the use of less efficient means of acquiring the same results, or to transfer the burden of increased cost to the taxpayers through guaranty programs. The question for scholars, for courts and ultimately for legislatures is whether society will have profited from the net changes when matters once again come into equilibrium.

Student Loans. The default rate for Guaranteed Student Loans rose to 12.5 percent in 1980. BUREAU OF THE CENSUS, STATISTICAL ABSTRACT OF THE UNITED STATES: 1981 163 (102d ed. 1981). By comparison, the delinquency rate—number of loans delinquent 30 days or more as a percentage of total installment loans outstanding—on bank installment loans in 1979 was 2.93 percent. Id. at 519.

*See supra* notes 20 and 21.