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The Slippery Slope to Bankruptcy - Should Some Claimants Get a 'Carve-Out' from Secured Credit? No: It's a Populist Craving for a Petit Bourgeois Valhalla

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bankruptcy **from secured credit?**

**No: It's a populist craving for a
petit bourgeois valhalla**
By James J. White

In 1996, Professor Elizabeth Warren made a proposal to the American Law Institute and the Drafting Committee for Article 9 for a "20 percent set aside" for unsecured claimants. As I understand it, her proposal would amend Section 9-301 of Article 9 (the section that now implicitly subordinates a lien creditor to a prior perfected secured creditor).

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Under her proposal, a creditor with a judicial lien would be entitled to 20 percent of the collateral of prior perfected secured creditors. Indeed, each succeeding lien creditor would be entitled to 20 percent of the remaining collateral after earlier claimants had taken their portion. Thus, if a secured creditor had a perfected security interest in oil worth \$100 million and had loaned \$100 million, a single-judgment creditor with a claim in excess of \$20 million would be entitled to \$20 million out of the collateral. If there were two creditors, each with a \$20 million claim, the first would be entitled to 20 percent of the \$100 million, the second would be entitled to \$16 million (20 percent of the remainder).

The intended beneficiaries of this are tort claimants, employees, environmental-pollution claimants and other "non-adjusting" creditors. According to Professor Woodward, trade creditors and other unsecured commercial lenders are not the intended beneficiaries or are, at most, incidental beneficiaries.

The idea appeals to an ancient, romantic notion that there should always be a small supper of free assets for the hungry who cannot or do not feed themselves. Persons (like me) who are unmoved by populist ideology are doubtful.

To analyze the merits of the proposal, consider three questions:

- Is there a problem, and if so, what?
- Assuming a problem, will the 20 percent set aside cure it?
- If the 20 percent set aside will cure or at least alleviate the problem, does the benefit conferred justify its cost?

According to Professor Woodward and most of the other proponents, the problem to be cured does not deal with contract creditors (suppliers, trade

creditors, junior secured creditors and the like) because they are presumed to know about security interests and to understand that secured creditors who have filed first will come ahead of them. They should charge accordingly.

To the extent that one believes trade creditors and the like need help from the legislature and are incapable of or unwilling to protect themselves, one might advocate the Warren proposal as protection for trade and other financial creditors. In my opinion, the proposal cannot be justified on that basis.

In some ways, trade creditors are the smartest, most agile and clever of

unpaid in many bankruptcies or — more accurately — the taxpayers have paid the cost.

But where is the evidence of a "problem?" Manville and Robins are sports — highly unusual cases. The same is true where debtors were driven into bankruptcy because of environmental liabilities. Are we to design our law based on a handful of anecdotes? I would make a small wager that if one dipped into a random selection of business bankruptcies, one would find that the losses fall principally on financial and other contract creditors, on the federal government (for unpaid

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all the creditors and I see no reason why legislators should protect them from the consequences of their own actions. They can and routinely do decide whether to lend and, if they lend, what to charge. An expansive secured credit system of the kind now embodied in Article 9 is simply one of the things they must consider.

According to Professor Woodward, the problem lies elsewhere; that tort creditors, employees and environmental-pollution claimants and their fellow travelers (all "nonadjusting" creditors) will go unpaid. How many tort or environmental claimants go unpaid? Surely there are famous environmental cases and there are doubtless a few mass tort claimants that go unpaid. In the most notorious tort-induced bankruptcies, Manville and Robins, most or all of the legitimate tort claims have been or will be paid. Surely some environmental claims must have gone

taxes), and only in the rarest of the rare, on tort claimants and the like.

Moreover, recent research suggests that secured credit is less pervasive than some think it to be. Professor Ronald Mann has suggested some of the reasons why creditors decline to insist on security and why debtors resist giving it.

The data that I have collected from the Compustat data base (financial data on nearly all American public companies) show that the median American company has granted security in less than 5 percent of its assets. Those same data show that in 1995 less than 20 percent of all American public companies have granted security in as much as one-fifth of their assets. In 1995, only 3 percent of American companies had granted security in more than half of their assets. Far from being the boogie man that gobbles up every free asset, security interests of any kind are only infre-

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quently granted by a typical American public firm. Mann's research suggests that personal property security is also less pervasive in private firms than might be thought. One would expect that the percentage of secured debt would rise as a company edges toward insolvency, but even in bankruptcy, I know of no data that suggest that the principal creditors are secured.

In a free society, parties who wish to impose restraints on alienation (that is, restraints on what a debtor can do with its own property) should bear the burden of showing why the debtor's freedom is to be restricted. The advocates of the set-aside proposal should be made to show that at a minimum, Article 9 is or will be used to stiff tort claimants, employees and others and that the cost to these injured parties outweighs the benefits of allowing the

al reward its intended beneficiaries.

Moreover, it is quite possible that junior secured creditors and unsecured contract creditors will use the proposal and so shove the intended beneficiaries away from the trough. Thus, if there is a problem, I doubt this is the solution.

The proper solution would be to ask Congress to amend the Bankruptcy Code or to enact other federal law to grant specific beneficiaries priority over specific persons. This is the pattern of the civil law in some countries. Federal law would do what an amendment to Article 9 cannot do: put all secured creditors (creditors secured under Article 9, real estate mortgagees and lessors et al.) and other claimants in the same position vis-a-vis the particular favored claimants. Moreover federal legislation could make a more reasoned and more explicit determination about who

now get credit. On the other hand, if the number of tort and employee creditors who use the set aside prove small (and if unintended beneficiaries like junior secured creditors can be excluded), it might have a modest long-range effect on secured lending.

If I understand the proposal correctly, the unintended beneficiaries are a significant problem; the proposal favors anyone with a judicial lien, not just nonadjusting creditors with liens. In setting their fees, senior secured creditors would have to be concerned not just about the torts or environmental contamination of its debtor, but also about junior secured creditors and other contract creditors. I suspect that junior secured creditors and other financial contract creditors are the most vigilant and would be the most likely to use the provision. If that is how the hand plays out, the enactment of the set aside will have turned the priority rules of Article 9 upside down for no apparent reason.

As I read him, Professor Woodward would not endorse such an outcome but would presumably say that a prior perfected secured creditor should be superior not only to unsecured contract creditors, but even more so to junior secured creditors — all of whom have bargained for a junior position (and presumably charged accordingly).

The proposal might also disrupt the priorities in bankruptcy. First it would allow the trustee in bankruptcy (a lien creditor under Section 544) to take up to 20 percent of a secured creditor's collateral in every bankruptcy. Depending on judicial interpretation and on how the law was written, it might also upset current rules on preferences, fraudulent conveyances and law on federal tax liens.

The proposal would drive some secured creditors to more expensive but more certain forms of security such as real estate mortgages, consignments, securitization and the like.

In short, the proposal would introduce significant uncertainty into secured lending under Article 9. Ultimately one

In the short run, the proposal would increase the cost of secured credit.

debtor to exercise its free will in the use of its own assets.

That case has not been made and I doubt that it can be.

Understand first what the carve-out will *not* do. Since the carve-out is an amendment to Article 9 (dealing only with security interests in personalty) it does not cover real estate mortgages or the priority of judicial or mechanics liens. It would also not affect securitization or a whole range of other modern and ancient non-Article 9 security devices such as consignments. Only in the rarest cases — where there are unpaid tort claimants or their ilk and where the assets are personal property otherwise completely absorbed by a personal property security interest — will the propos-

should benefit from such a proposal and who should suffer its consequences.

The advocates of the proposal do not favor a federal law perhaps because they believe they cannot get Congress to adopt one. If Congress is satisfied with the modest priorities now given in Section 507(a) to employees and the like and is content to allow tort claimants to have priority only to the extent of insurance and not more, where is the virtue in a rule in Article 9 to the contrary?

At least in the short run, the proposal would increase the cost of secured credit in personal property. Conceivably some who would now lend at 8 percent would demand 9 percent in the proposed regime. Others might refuse marginal debtors who

would expect secured creditors to measure and calculate the amount of that uncertainty and to alter their behavior accordingly. They might alter it by refusing to lend, by raising their interest rates, or in some cases by taking a form of security other than Article 9 security.

Although I cannot prove it, I suspect that the change so induced would be inefficient — even after the initial uncertainty subsided. A proposal of this kind is efficient only if the added costs that are imposed on the system and passed on by the secured creditors are justified by offsetting reductions in cost or by gains to unsecured creditors. In theory, the beneficiaries (junior secured creditors, unsecured creditors and non-adjusting creditors), should be willing to lend at a lower price. If that does not prove to be true, the proposal will be inefficient — unless of course the value of other gains to the nonadjusting creditors equals or exceeds the cost of higher interest charges and declining credit.

A second cost — one only indirectly related to efficiency — is the political cost arising from the government's interference with a debtor's free use of its own property. Although the proposal is characterized only as a "carve-out," it is in fact a restraint on alienation, a restriction on the power of an owner to dispose of its own property as it pleases. I at least regard every governmental restriction on citizens' freedom as costly.

In conclusion, I suspect that secured creditors could live with almost any modification of Article 9 that can be imagined — this one included. I also suspect that this proposal would cause substantial short-term inefficiencies and that it might produce long-term inefficiencies. There is even a possibility of significant, unintended consequences — namely, of the proposal's use principally by junior secured creditors to achieve priority that has been explicitly denied them under Article 9. That, of course, would be quite perverse — to elevate a person who had filed sec-

ond over the one who had filed first, simply because the second hurries to court and gets a judgment.

So, I oppose this scheme mostly on the ground that the proponents have not yet made a case for it. Where — beyond a populist craving for a petit bourgeois valhalla — is the political

justification for such a restriction on the use of private property? Where — beyond anecdotes — is the evidence showing injury to tort claimants, environmental claimants, employees and the like? I doubt there is any such evidence or any satisfactory political rationale.

If there is none, no problem. 