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## Secured Creditors Under the Bankruptcy Reform Act

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### I. INTRODUCTION

"[T]he theme of the Bankruptcy Act is equality of distribution."<sup>1</sup> Although Mr. Justice Douglas liked to stress that theme in his opinions for the Supreme Court construing the Bankruptcy Act,<sup>2</sup> there are many dissonances in bankruptcy. The rights of secured creditors in the estates of their debtors were extensively recognized in the Bankruptcy Act<sup>3</sup> and are still more fully particularized in the Bankruptcy Reform Act of 1978.<sup>4</sup> The reconciliation of the competing claims of secured and unsecured creditors has been a principal concern of the drafters of the bankruptcy laws and is the focus of the contributions to this symposium.

Security is a hedge against bankruptcy and other manifestations of the debtor's insolvency. To the extent a secured creditor obtains protection against the necessity of sharing in the losses suffered by other creditors of an insolvent debtor, he frustrates a fundamental bankruptcy objective. Notwithstanding all the virtues of equality, however, vindication of this objective of bankruptcy is not the only relevant consideration in a system of credit and credit administration. Extension of credit is, at least generally, a voluntary act on the part of the creditor. Borrowers and purchasers of property and services vary in their creditworthiness. The risk of nonpayment by some debtors is so serious that they are unable to obtain credit without giving security. Some lenders and vendors are generally unwilling to extend any credit without taking security. Even when a prospective debtor is creditworthy and the creditor is able and willing to extend unsecured credit, secured credit may be cheaper or more easily obtainable.

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<sup>1</sup>*Sampson v. Imperial Paper & Color Corp.*, 313 U.S. 215, 219 (1941).

<sup>2</sup>*See also Nathanson v. NLRB*, 344 U.S. 25, 29 (1952).

<sup>3</sup>The Bankruptcy Act is the title given the Bankruptcy Act of 1898, as amended many times before and after 1950, by Pub. L. No. 879, 64 Stat. 1113 (1950). The Bankruptcy Act was repealed by Pub. L. No. 95-598, § 401(a), 92 Stat. 2682 (1978).

<sup>4</sup>Pub. L. No. 95-598, 92 Stat. 2549 (1978).

Accordingly, the bankruptcy laws of the United States (and of other countries as well)<sup>5</sup> recognize the necessary role of secured credit by permitting the enforcement, subject to limitations, of the rights of secured creditors. The bankruptcy laws of the United States have treated as a secured creditor only one who is secured by a lien against property.<sup>6</sup> A creditor who obtains in addition to his claim against the debtor the personal obligation of another is accorded certain rights appropriate to his position<sup>7</sup> but is not a secured creditor in the context of this discussion. A secured creditor under the bankruptcy laws holds an interest in or charge against property of the debtor whose estate is being administered,<sup>8</sup> but these laws have increasingly differentiated in their treatment of various kinds of secured claims by reference to the nature and origin of the lien of the creditor.<sup>9</sup>

## II. NONCONSENSUAL LIENS

The original lien at common law is one that arises by operation of law in favor of an artisan or other bailee who renders a kind of service respecting personal property.<sup>10</sup> Not every bailee rendering service respecting personal property has been protected by a common-law lien, and a common-law lienor is accorded only the right to retain the property subject to the lien until the debt incurred for the service is paid. Common-law liens include those given a carrier, a warehouseman, a landlord, an innkeeper, and a seller.<sup>11</sup> With a minor qualification,<sup>12</sup> this variety of lien has always been enforceable under the bankruptcy laws.

Common-law liens have for the most part been superseded in

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<sup>5</sup>EUROPEAN BANKRUPTCY LAWS 58 (the law of Austria), 71 (the law of Belgium), 96-97 (France), 126-27 (Germany), 145 (Sweden) (I. Ross ed. 1974).

<sup>6</sup>See section 1(28) of the Bankruptcy Act, 11 U.S.C. § 1(28) (1976) (repealed 1978), and sections 101(28) & 605(a) of Title 11 of the United States Code as enacted in 1978. It is to be noted that the Bankruptcy Reform Act does not use the term "secured creditor." See note 66 *infra* and accompanying text.

<sup>7</sup>Thus he is protected against competition by the codebtor in the latter's pursuit of a right of reimbursement, subrogation, or contribution. See 11 U.S.C. § 509(c) (Supp. IV 1980). This subordination provision in the Bankruptcy Reform Act codifies the prior case law.

<sup>8</sup>11 U.S.C. §§ 101(28), (37) (Supp. IV 1980).

<sup>9</sup>See notes 61-65 *infra*.

<sup>10</sup>7 W. HOLDSWORTH, A HISTORY OF ENGLISH LAW 511 (1926).

<sup>11</sup>*Id.* at 511-13; 2 G. GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY § 33.2 (1965).

<sup>12</sup>Common-law liens of distraint for rent were subordinated and restricted by section 67c of the Bankruptcy Act. 4 W. COLLIER, BANKRUPTCY ¶ 67.28[1] (14th ed. W. Moore 1978). They are voidable by the trustee under the Bankruptcy Reform Act. 11 U.S.C. §§ 101 (38), 545(4) (Supp. IV 1980).

practice by legislation creating statutory liens that accord more effective and more complete protection to those creditors favored by the legislature. A statutory lien is typically enforceable by sale upon compliance with statutory and relevant constitutional procedures.<sup>13</sup> A statutory lien may also secure a creditor without reference to any bailment of goods and may cover real property. Thus statutory liens include mechanics' liens on real estate and liens for taxes on both real estate and personal property. While the bankruptcy laws originally did not differentiate in their treatment of common-law and statutory liens, the proliferation of statutory liens and a developing sensitivity to the resulting frustration of the policy of the bankruptcy laws led to the introduction of restrictions on the enforcement of statutory liens by the Chandler Act in 1938.<sup>14</sup> These restrictions have since been extended.<sup>15</sup>

A variety of lien palpably offensive to the bankruptcy policy of equal distribution is one obtained by an unsecured creditor through the prosecution of judicial proceedings against an insolvent debtor. Thus the bankruptcy laws have treated this kind of lien as a form of voidable preference if obtained against an insolvent debtor within a prescribed period before the inception of administration of a

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<sup>13</sup>For example, the statutory requirements for enforcing a warehouseman's lien as found in U.C.C. § 7-210. Whether acts of enforcement of a statutory lien amount to state action, subjecting the statute to constitutional scrutiny, depends upon the degree of involvement of a state functionary or institution. *Flagg Bros., Inc. v. Brooks*, 436 U.S. 149 (1978) (no state action found where statute merely authorized procedure for self-help). For a discussion of the constitutional problems engendered by the enforcement of statutory liens, see Note, *Creditors' Remedies as State Action*, 89 YALE L.J. 538 (1980); Note, 23 VILL. L. REV. 419 (1978).

<sup>14</sup>Statutory liens on personalty unaccompanied by possession and liens of distress for rent were subordinated to the first two classes of unsecured claims entitled to priority, and liens for wages and rent were restricted. Chandler Act ch. 575, § 67c, 52 Stat. 840, 877 (1938); Kennedy, *Statutory Liens in Bankruptcy*, 39 MINN. L. REV. 697, 703-16 (1955).

<sup>15</sup>In 1952 most statutory liens on personalty unaccompanied by possession were invalidated as against the trustee. Kennedy, *supra* note 14, at 716-22. In 1966, statutory liens were invalidated as against the trustee if: (1) like a priority, they were operative only on insolvency or in the event of a general distribution of the debtor's property; (2) they were not effective against a bona fide purchaser from the debtor; or (3) they constituted liens of distress for rent. Moreover, tax liens on personalty unaccompanied by possession were postponed to the first two classes of priority claims. Bankruptcy Act §§ 29(a) and 67c as amended by 80 Stat. 268, 268-69 (1966). The Bankruptcy Reform Act of 1978 allows a pre-petition payment or transfer of his property by the debtor in discharge of a statutory lien to be attacked as a preference for the first time, and in liquidation cases a tax lien is subordinated to all the priority claims except those for taxes. 11 U.S.C. §§ 545, 547, 724(b); Schneyer, *Statutory Liens Under the New Bankruptcy Code—Some Problems Remain*, 55 AM. BANKR. L.J. 1 (1981).

debtor's estate.<sup>16</sup> Although a lien obtained by judicial proceedings is typically created and regulated by statute, the term "statutory lien" as used here and in the bankruptcy laws generally does not include a lien obtainable by an unsecured creditor in pursuing his judicial remedies for collection. Judicial liens include those obtained incident to judgment, execution, attachment, garnishment, creditor's bill, and proceedings supplementary to execution.

A lien obtained by an agreement between a debtor and his creditor is no less offensive to the bankruptcy policy of equal treatment of all creditors than is one obtained by the unilateral action of a creditor through judicial proceedings. Although the bankruptcy laws have generally been more considerate of the position of a consensual lienor than of a judicial lienor in the avoidance sections,<sup>17</sup> the differentiation has been diminishing and has nearly disappeared in the Bankruptcy Reform Act.<sup>18</sup> Consensual liens include real estate mortgages, security interests in personal property, and miscellaneous other types of encumbrances arising out of agreements to give security.<sup>19</sup>

The variety of lien known as an "equitable lien" has been characterized as neither equitable nor a lien because it confers an inequitable advantage over other unsecured creditors but does not prevail against a bona fide purchaser.<sup>20</sup> An equitable lien is a shorthand term for a species of relief given by a court of equity to a creditor.<sup>21</sup> Thus equity courts have typically awarded such a lien to a

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<sup>16</sup>This kind of lien was voidable by the trustee without regard to the state of the creditor's mind under section 67 of the Bankruptcy Act, if obtained during insolvency and within four months of the filing of a petition by or against the debtor. J. MACLACHLAN, HANDBOOK OF THE LAW OF BANKRUPTCY § 202 (1956).

<sup>17</sup>Thus, until enactment of the reform effected by section 547(b) of the Bankruptcy Code, reasonable cause to believe that the debtor was insolvent was required to be shown by the trustee seeking to avoid any consensual lien as a preference under the Bankruptcy Laws, whereas no such requirement was imposed when the trustee sought to avoid a judicial lien. *See id.*

<sup>18</sup>The differentiation of the treatment of judicial liens and consensual liens as preferential transfers is largely eliminated by section 547 of the Bankruptcy Code. *See* 4 COLLIER ON BANKRUPTCY ¶ 547.12 (15th ed. L. King 1981) [hereinafter cited as COLLIER (15th ed.)].

<sup>19</sup>A consensual lien is a "security interest" under section 101(37). The term as used in the Bankruptcy Reform Act has a broader connotation than as used in the Uniform Commercial Code in that it extends to interests in real property. H.R. REP. NO. 595, 95th Cong., 1st Sess. 314 (1977), *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS 5963, 6271.

<sup>20</sup>*See* 1 G. GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY 200 (1965) ("Like the Holy Roman Empire, which was said to be neither holy nor Roman nor an empire, the equitable lien is neither equitable nor a lien").

<sup>21</sup>*See* Britton, *Equitable Liens—A Tentative Analysis of the Problem*, 8 N.C.L. REV. 388 (1930); Glenn, *The "Equitable Pledge," Creditors' Rights, and the Chandler Act*, 25 VA. L. REV. 422 (1939).

lender of funds for purchasing or improving real property when the loan is made in reliance on a promise to give security in the property.<sup>22</sup> Equitable liens against personal property have well nigh disappeared from cases administered under the bankruptcy laws since the general adoption of the Uniform Commercial Code,<sup>23</sup> and they do not appear frequently in cases involving real property.<sup>24</sup> The bankruptcy laws have been increasingly hostile to such a lien,<sup>25</sup> and the Bankruptcy Reform Act carries the attack further than previous legislation.<sup>26</sup>

A maritime lien, like a common-law or statutory lien, ordinarily arises by operation of law.<sup>27</sup> A maritime lien is nevertheless a distinctive category subject to different rules respecting its origin, nature, validity, and priority. The bankruptcy laws have been silent

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<sup>22</sup>See 51 AM. JUR. 2d *Liens* §§ 33-34 (1970).

<sup>23</sup>Morris, *Bankruptcy Law Reform: Preferences, Secret Liens and Floating Liens*, 54 MINN. L. REV. 737, 753 (1970); but see *Warren Tool Co. v. Stephenson*, 111 Mich. App. 274, 161 N.W.2d 133 (1968), criticized in Note, *Security Agreements, Equitable Liens, and the Uniform Commercial Code*, 69 COLUM. L. REV. 1280 (1969).

There is no reference to "equitable liens" in the index to J. WHITE & R. SUMMERS, *UNIFORM COMMERCIAL CODE* (2d ed. 1980); see also 1 G. GILMORE, *SECURITY INTERESTS IN PERSONAL PROPERTY* 155, 199-200 (1965); 2 *id.* at 1302.

A notable exception to the demise of equitable liens against personal property is the equitable right of subrogation accorded a surety on a construction bond against a fund retained by the obligor of a construction contract. This right, often called an "equitable lien," has been allowed to prevail as against a trustee in bankruptcy of the contractor. *Pearlman v. Reliance Ins. Co.*, 371 U.S. 132 (1962); Kennedy, *The Inchoate Lien in Bankruptcy: Some Reflections on Rialto Publishing Co. v. Bass*, 17 STAN. L. REV. 793, 817-18 (1965).

<sup>24</sup>The index to the multivolume 15th edition of *Collier on Bankruptcy* contains no entry under the heading of "equitable lien" or any similar rubric. Similarly the successor to Professor Osborne's *Hornbook on Mortgages*, G. OSBORNE, G. NELSON, & D. WHITMAN, *REAL ESTATE FINANCE LAW* (1979), contains no index entries for "equitable liens" or "equitable mortgages." Compare, e.g., G. OSBORNE, *HANDBOOK ON THE LAW OF MORTGAGES* ch. 2 (2d ed. 1951), where equitable mortgages are discussed at length.

<sup>25</sup>See 1 G. GILMORE, *SECURITY INTERESTS IN PERSONAL PROPERTY* § 7.2 (1965); 2 *id.* §§ 45.3.3, 45.4.

<sup>26</sup>The trustee will prevail over most equitable liens in personal property as a hypothetical lien creditor under section 544(a)(3). The Bankruptcy Reform Act includes no insurance policy against the repetition by an obdurate court of such a decision as *Porter v. Searle*, 228 F.2d 748 (10th Cir. 1955) (repossession of stock of merchandise on the eve of bankruptcy by an equitable lienor sustained against attack by the trustee under section 60 of the Bankruptcy Act), criticized in 2 G. GILMORE, *SECURITY INTERESTS IN PERSONAL PROPERTY* § 45.7 (1965) and MacLachlan, *The Title and Rights of the Trustee in Bankruptcy*, 14 RUTGERS L. REV. 653, 676 (1960).

<sup>27</sup>See Landers, *The Shipowner Becomes a Bankrupt*, 39 U. CHI. L. REV. 490, 510, 512 (1972). A recent appellate court decision treated a maritime lien in a bankruptcy case as a statutory lien. *In re Mission Marine Assocs., Inc.*, 633 F.2d 678 (3d Cir. 1980). See also Landers, *supra*, at 512-14. Maritime liens nevertheless may sometimes apparently arise by agreement of the parties. *Id.* at 512.

in regard to maritime liens, and the case law governing the treatment of such liens in a bankruptcy context is not well developed. The express grant to bankruptcy courts by the Bankruptcy Reform Act of the powers of a court of admiralty<sup>28</sup> may lead to the formulation of more distinct rules and a clarification of this area of bankruptcy.

### III. CONSENSUAL LIENS: THE LAW PRIOR TO 1978

As already intimated, the bankruptcy laws have become increasingly specific in dealing with the rights of secured creditors. The general tendency of this legislation has been to restrict those rights in the interest of facilitating attainment of the objectives of the bankruptcy laws to effect equality of distribution and to afford a fresh start for the debtor. The first two bankruptcy laws of the United States made only brief, oblique references to secured creditors or liens.<sup>29</sup> The Bankruptcy Act of 1867 contained the first explicit provision protecting valid security interests against the statutory representative of the unsecured creditors.<sup>30</sup>

The Bankruptcy Act of 1898 began a deliberate attack on certain liens by defining the word "transfer" to include a conditional parting with property as security,<sup>31</sup> invalidating preferential and fraudulent transfers,<sup>32</sup> and by including in a section entitled "Liens" provisions that enabled the trustee to avoid liens under prescribed conditions.<sup>33</sup> The trustee's hand was substantially strengthened in 1910 by the enactment of the strong-arm clause, which enabled the trustee to avoid any lien that could have been defeated under nonbankruptcy law by a judicial lien creditor on the date of the filing of a petition by or against the bankrupt.<sup>34</sup> This provision originally endowed the

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<sup>28</sup>28 U.S.C. § 1481 (Supp. IV 1980).

<sup>29</sup>A principal concern of the drafters of the Bankruptcy Acts of 1800 and 1841 was that the bankrupt estate should be able to obtain the benefit of the debtor's right to redeem property subject to a secured creditor's lien. *See* Bankruptcy Act of 1800, ch. 19, § 12, 2 Stat. 19, 24-25 (repealed 1803); Bankruptcy Act of 1841, ch. 9, § 11, 5 Stat. 440, 447 (repealed 1843). The Act of 1800 also contained a provision that a creditor having a judicial or statutory security not yet enforced by a pre-petition levy of execution should not be allowed a preference in distribution over other creditors. Act of 1800, § 31, 2 Stat. at 30.

<sup>30</sup>Ch. 176, § 14, 14 Stat. 517, 523-24 (repealed 1878). This section also contained authority for the liquidator of the estate to redeem the bankrupt's property from the lien of a secured creditor or to sell the property subject to the lien. *See also id.* § 20, 14 Stat. at 526.

<sup>31</sup>Ch. 541, § 1(25), 30 Stat. 544, 545 (repealed 1978).

<sup>32</sup>*Id.* §§ 60, 67c, 30 Stat. at 562, 564.

<sup>33</sup>*Id.* § 67a (unperfected liens), 67c (liens of judicial proceedings), and 67f (liens of legal proceedings), 30 Stat. at 564, 565.

<sup>34</sup>Act of June 25, 1910, ch. 412, § 8, 36 Stat. 838, 840 (repealed 1978) (amending Bankruptcy Act of 1898, ch. 541, § 47a(2), 30 Stat. 544, 557).

trustee with the lien of a judicial proceeding only in respect to property in the custody of the bankruptcy court,<sup>35</sup> but in 1952 the hypothetical lien was given the trustee without regard to who had possession.<sup>36</sup> The strong-arm clause has proved to be a valuable weapon to the trustee defeating unperfected liens, particularly such liens on personal property.<sup>37</sup>

The crucible for subjecting security to the severest test is usually recognized to be the preference provisions of the bankruptcy laws. The effectiveness of the preference law in enabling the trustee to overcome a security interest has been significantly strengthened by a series of statutory changes beginning in 1938. Congress had made noteworthy efforts earlier to deal with the use of security interests to frustrate the preference policy of the bankruptcy laws. A series of amendments enacted prior to 1938 were intended to render vulnerable to avoidance security interests perfected within the four months before bankruptcy.<sup>38</sup> These efforts developed out of a recognition that secret liens offend bankruptcy policy. The doctrine of reputed ownership, which evolved from *Twyne's Case*,<sup>39</sup> rendered secret security interests void or voidable by unsecured creditors as a form of fraud. Peter Coogan has observed that the history of secured credit for the last two hundred years is largely a record of the efforts of unsecured creditors to force secured creditors to disclose their security and of the efforts of secured creditors to find ways of circumventing the legal strictures imposed on them at the instigation of unsecured creditors.<sup>40</sup> The strong-arm clause was enacted to enable the trustee in bankruptcy to invoke the doctrine of reputed ownership in the various forms in which it had been adopted by the states.<sup>41</sup> But the doctrine did not help the creditors or the trustee in most states if the secured creditor succeeded in taking possession or otherwise perfecting his interest before levy by any unsecured creditor or attachment of the trustee's hypothetical lien. To allow a secured creditor to prevail against the trustee notwithstanding belated perfection on the eve of bankruptcy ran counter to bankruptcy policy

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<sup>35</sup>With respect to property not in the custody of the court, the trustee was given the rights, remedies, and powers of a judgment creditor with an execution returned unsatisfied. As a practical matter, these rights have been of little use to the trustee.

<sup>36</sup>Act of July 7, 1952, Pub. L. No. 456, § 23(b), 66 Stat. 420, 430 (repealed 1978).

<sup>37</sup>See 4B COLLIER ON BANKRUPTCY ¶¶ 70.55-.62A (14th ed. W. Moore 1978).

<sup>38</sup>Act of Feb. 5, 1903, ch. 487, § 13, 32 Stat. 797, 799-800; Act of June 25, 1910, ch. 412, § 11, 36 Stat. 838, 842; Act of May 27, 1926, ch. 406, 44 Stat. 662, 666.

<sup>39</sup>76 Eng. Rep. 809 (Star Chamber 1601).

<sup>40</sup>Coogan, *Public Notice Under the Uniform Commercial Code and Other Recent Chattel Security Laws, Including "Notice Filing,"* 47 IOWA L. REV. 289, 289 (1962).

<sup>41</sup>45 CONG. REC. 2277 (1910).

in two respects: the belatedly perfected security interest was indistinguishable in observable effects from a security interest created on the eve of bankruptcy to secure an antecedent debt; and the secrecy of the lien pending the perfection was potentially prejudicial to creditors who extended credit on the assumption that the secret lienor was not secured. The effort to deal with this problem finally succeeded in 1938 with the incorporation of a bona fide purchaser test in the preference section for the purpose of determining the time when a transfer to a creditor occurs.<sup>42</sup> That turned out to be overkill because security interests in inventory and certain other kinds of personalty are never perfected against some bona fide purchasers.<sup>43</sup> An amendment to the preference section introducing a lien creditor test with respect to personalty was added in 1950.<sup>44</sup>

Although a security interest for a contemporaneous consideration, if promptly perfected, has generally withstood attack by the trustee in bankruptcy, the Chandler Act attempted codification of the Supreme Court precedent of *Dean v. Davis*,<sup>45</sup> which invalidated a mortgage for a present loan because the purpose of the loan was to enable the debtor to make a preferential payment to a particularly insistent creditor.

The most dramatic development in the law of security in this country occurred during the following two decades. All but one American state adopted Article 9 of the Uniform Commercial Code.<sup>46</sup> The Code simplified the law of personal property security and significantly improved the position of secured creditors in competition with unsecured creditors. A result was an enormous expansion in the use of inventory and accounts receivable as collateral by business borrowers. At the same time the Code facilitated a vast expansion of consumer credit, both secured and unsecured. A troublesome problem generated by this development involved the status of a security interest created in collateral acquired on the eve of bankruptcy to secure an antecedent debt. The Uniform Commercial Code sanctioned

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<sup>42</sup>Chandler Act, ch. 575, § 60, 52 Stat. 840, 869 (1938) (repealed 1978).

<sup>43</sup>See *Corn Exchange Nat'l Bank & Trust Co. v. Klauder*, 318 U.S. 434 (1943) (striking down an assignment of accounts receivable). See also 2 G. GILMORE, SECURITY INTEREST IN PERSONAL PROPERTY 1302 (1965) ("In the entire history of statutory drafting, the 1938 revision of § 60 is the classical example of overkill").

<sup>44</sup>Act of March 18, 1950, ch. 70, § 60, 64 Stat. 24, 26 (1950) (repealed 1978).

<sup>45</sup>242 U.S. 438 (1917). There were two attempts at codification in section 67d(3) of the Bankruptcy Act. The original version enacted in 1938 was amended in 1952. Act of July 7, 1952, ch. 579, 66 Stat. 420, 428 (1952) (repealed 1978). The difficulties presented by this legislation are discussed in 4 COLLIER ON BANKRUPTCY ¶ 67.38 (14th ed. W. Moore 1978).

<sup>46</sup>The lone state is Louisiana. The record of enactment of the Code is set out tabularly in 1 U.L.A. 1-2 (Supp. 1981).

such a security arrangement,<sup>47</sup> but it appeared to conflict with the preference policy of the Bankruptcy Act, especially when the collateral acquired on the eve of bankruptcy did not replace other collateral acquired earlier. Judicial resolution of this problem created the possibility of easy frustration of the preference policy by allowing any creditor to obtain protection from the trustee's use of the preference provisions of the Bankruptcy Act by filing a financing statement when the credit was extended.<sup>48</sup>

The treatment of valid secured claims was largely left to implication by the Bankruptcy Act. The enforceability of liens to the exclusion of priority and general unsecured claims was a matter of inference, and the relative priority of liens was governed by non-bankruptcy law except in the limited situation where a security interest was junior by nonbankruptcy law to a lien invalidated or postponed by the Bankruptcy Act.<sup>49</sup> Provision was made for determining the amount of a deficiency owing an undersecured creditor.<sup>50</sup> The right of the trustee to sell property of the estate free of liens was established by case law.<sup>51</sup>

The foregoing observations have been confined to the effect of the provisions of the Bankruptcy Act that applied in straight bankruptcy—that is, liquidation—rather than reorganization or rehabilitation under a plan. Beginning in 1933 Congress enacted reorganization legislation for railroads and corporations<sup>52</sup> that assured secured creditors of absolute priority of their interests in an enterprise reorganized under the legislation.<sup>53</sup> If the secured creditor did

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<sup>47</sup>See U.C.C. §§ 9-108, -204(3) (1962 Official Text). See 2 G. GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY §§ 45.6-7 (1965).

<sup>48</sup>See, e.g., *DuBay v. Williams*, 417 F.2d 1277 (9th Cir. 1969); *Grain Merchants of Indiana, Inc. v. Union Bank & Sav. Co.*, 408 F.2d 209 (7th Cir.), cert. denied, 396 U.S. 827 (1969); *Rosenberg v. Rudnick*, 262 F. Supp. 635 (D. Mass. 1967).

<sup>49</sup>The Bankruptcy Act generally dealt with such situations, creating a potential windfall for the junior lienor or generating circuitry of priority, by preserving the impaired lien for the benefit of the estate. See Kennedy, *The Trustee in Bankruptcy as a Secured Creditor Under the Uniform Commercial Code*, 65 MICH. L. REV. 1419, 1434-39 (1967).

<sup>50</sup>Bankruptcy Act of 1898, ch. 541, § 57h, 30 Stat. 544, 560, superseded by BANKR. R. 306(d).

<sup>51</sup>The leading case is *Van Huffel v. Harkelrode*, 284 U.S. 225 (1931).

<sup>52</sup>The first reorganization statute was section 77, the railroad reorganization law. Act of March 3, 1933, ch. 204, §§ 77, 47 Stat. 1467, 1474. This statute was followed by section 77B, the first general corporate reorganization law. Act of June 7, 1934 ch. 424, § 77B, 48 Stat. 911, 912. Section 77 was not amended by the Chandler Act, but section 77B was superseded by Chapters X and XI of that Act.

<sup>53</sup>This guaranty was embodied in the "fair and equitable" standard imposed as a requirement for confirmation of a reorganization plan. Act of March 3, 1933, ch. 204, § 77(e)(1), 47 Stat. 1467, 1478; Chandler Act, ch. 575, § 221(2), 52 Stat. 840, 897 (1938);

not consent to the provision made for it in the plan, it was protected by a statutory guaranty of receipt of the full value of its claim against the debtor's property.<sup>54</sup> Relief afforded political subdivisions by legislation enacted in the mid-1930's also protected the absolute priority of secured creditors.<sup>55</sup>

Rehabilitation legislation enacted by the Chandler Act of 1938 also dealt with security interests in realty owned by a debtor other than a corporation<sup>56</sup> and with security interests in personalty owned by a wage earner.<sup>57</sup> The secured creditor of a wage earner was protected against any modification of his lien against personalty without his consent in a Chapter XIII case,<sup>58</sup> but the creditor of a noncorporate debtor secured by realty might be subjected to cramdown by the court's confirmation of a plan under Chapter XII that provided the creditor with the appraised value of his interest in the realty.<sup>59</sup> The bankruptcy court was empowered in any rehabilitation case to enjoin enforcement of a lien during the pendency of the case.<sup>60</sup>

#### IV. CONSENSUAL LIENS UNDER THE BANKRUPTCY REFORM ACT

The Bankruptcy Reform Act is more explicit in regard to the

Consolidated Rock Prods. Co. v. Du Bois, 312 U.S. 510 (1941) (construing the "fair and equitable" requirement of § 231(1)); Case v. Los Angeles Lumber Prods. Co., 308 U.S. 106 (1939) (similarly construing the same requirement of § 77B(f)(1)).

<sup>54</sup>When a secured creditor or class of secured creditors did not accept the provisions of a plan in a Chapter X case affecting its rights, adequate protection of the value of their claims was required to be provided by § 216(7) governing "cramdown." See, e.g., Wachovia Bank & Trust Co. v. Harris, 455 F.2d 841 (4th Cir. 1972). A comparable provision enabled the court to confirm a plan under section 77 cashing out secured creditors without their acceptance if the payment covered the value of their interests. Act of March 3, 1933, ch. 204, § 77(e), 47 Stat. 1467, 1478.

The "fair and equitable" requirement and the cramdown provision did not apply in Chapter XI cases, but secured creditors' rights could not be affected by a Chapter XI plan. *But see* R.I.D.C. Indus. Dev. Fund v. Snyder, 539 F.2d 487 (5th Cir. 1976), *cert. denied*, 429 U.S. 1095 (1977) (sustaining provisions of a confirmed Chapter XI plan altering a secured creditor's rights with its consent).

<sup>55</sup>Act of August 16, 1937, ch. 657, § 83(e), 50 Stat. 653, 658.

<sup>56</sup>Chandler Act, ch. 575, §§ 606(1), 646(2), 52 Stat. 840, 930, 934.

<sup>57</sup>*Id.* § 652(1), 52 Stat. at 934.

<sup>58</sup>*Id.* § 461(11), 52 Stat. at 922.

<sup>59</sup>*Id.* § 468(1), 52 Stat. at 923.

<sup>60</sup>11 U.S.C. §§ 205(j), 402(c), 516(4), 714, 814, 1014 (1976) (repealed 1978) (Bankruptcy Act §§ 77(j), 83(c), 116(4), 314, 414, 614); *see also id.* § 11(a)(15) (Bankruptcy Act § 2a(15)). Automatic stays were provided by *id.* § 548 (Bankruptcy Act § 148) in a Chapter X case and *id.* § 828 (Bankruptcy Act § 428) and possibly *id.* § 907 (Bankruptcy Act § 507) in a Chapter XII case. These statutory provisions were supplemented by automatic stays provided by Bankruptcy Rules 8-501, 9-4, 10-601, 11-44, 12-43, and 13-401. See Kennedy, *The Automatic Stay in Bankruptcy*, 11 U. MICH. J.L. REF. 177, 177 n.1 (1978).

rights of secured creditors than any previous bankruptcy legislation. Numerous rights of secured creditors and limitations on those rights declared in the new law were in doubt under prior law. A number of limitations are new, and in a few respects secured creditors are given rights never before recognized in bankruptcy legislation.

### A. *Valid Liens*

The Bankruptcy Reform Act not only defines "statutory lien"<sup>61</sup> as did the Bankruptcy Act<sup>62</sup> but also defines "lien,"<sup>63</sup> "judicial lien,"<sup>64</sup> and "security interest."<sup>65</sup> Although setoff is not made a lien by definition, the new law treats it as one.<sup>66</sup> A section entitled "Determination of secured status" is crucial to the secured creditor's rights: it spells out the fact that an undersecured creditor has two claims—a secured claim limited by the value of the interest constituting the security and an unsecured claim in the amount of the deficiency;<sup>67</sup> it negates an argument that a valuation of the security for one purpose is thereafter conclusive for other purposes;<sup>68</sup> it specifies the right of a creditor to post-petition interest when his claim is covered by sufficient collateral, and to attorneys' fees, even though the latter may not be collectible under nonbankruptcy law;<sup>69</sup> and it subjects the security interest to the expenses of preservation and enforcement.<sup>70</sup> An innovative proposal that a secured claim must be proved in order to be allowed did not survive,<sup>71</sup> but it is provided

<sup>61</sup>11 U.S.C. § 101(38) (Supp. IV 1980) provides:

"statutory lien" means lien arising solely by force of a statute on specified circumstances or conditions, or lien of distress for rent, whether or not statutory, but does not include security interest or judicial lien, whether or not such interest or lien is provided by or is dependent on a statute and whether or not such interest or lien is made fully effective by statute . . . .

<sup>62</sup>11 U.S.C. § 1(29a) (1976) (repealed 1978). The two definitions are practically identical except for the inclusion in the 1978 act of a "lien of distress for rent, whether or not statutory" and the clarifying exclusion of a "security interest or judicial lien."

<sup>63</sup>*Id.* § 101(28) provides: "'lien' means charge against or interest in property to secure payment of a debt or performance of an obligation."

<sup>64</sup>*Id.* § 101(27) provides: "'judicial lien' means lien obtained by judgment, levy, sequestration, or other legal or equitable process or proceeding."

<sup>65</sup>*Id.* § 101(37) provides: "'security interest' means lien created by an agreement."

<sup>66</sup>*See, e.g., id.* § 506(a) which provides: "An allowed claim of a creditor . . . that is subject to setoff under section 553 of this title is a secured claim . . . to the extent of the amount subject to setoff . . ." *See also* 124 CONG. REC. 32,398 (1978) (Congressman Edwards' statement); *id.* at 33,997 (1978) (Senator DeConcini's statement).

<sup>67</sup>11 U.S.C. § 506(a) (Supp. IV 1980).

<sup>68</sup>*Id.*

<sup>69</sup>*Id.* § 506(b); 124 CONG. REC. 32,398 (1978) (Congressman Edwards' statement); *id.* at 33,997 (1978) (Senator DeConcini's statement).

<sup>70</sup>11 U.S.C. § 506(c).

<sup>71</sup>H.R. 6, 95th Cong., 1st Sess. § 506(d) (1977).

that if a challenge or a request directed at a security interest is filed, proof is required to save it from invalidity.<sup>72</sup>

The Bankruptcy Reform Act imposes an automatic stay of most litigation, proceedings, and acts against the debtor and his property from the moment a petition is filed by or against the debtor.<sup>73</sup> The impact of this stay falls most heavily on secured creditors, who are thereby prevented from enforcing their rights in their security unless and until they obtain relief. The statutory provisions for the stay are, however, largely a continuation of prior law. Although limited automatic stays were provided for in only two of the rehabilitation chapters enacted in 1938,<sup>74</sup> Rules of Bankruptcy Procedure promulgated in 1973-1976 covered much of the same ground as the statutory stay.<sup>75</sup> A significant difference in the statutory stay is the explicit requirement for relief from the stay on request if the complainant is not provided adequate protection of his interest or the debtor lacks equity in property not necessary for reorganization.<sup>76</sup>

A significant new section explicitly authorizes and regulates the use of collateral by a debtor during the pendency of a case.<sup>77</sup> The legislation codifies and extends the fragmentary case law respecting such use that developed under the Bankruptcy Act.<sup>78</sup> The same section spells out the bankruptcy court's authority to sell property free of a lien.<sup>79</sup>

The Bankruptcy Reform Act recognizes more fully than did the Bankruptcy Act the power of the bankruptcy court to subordinate

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<sup>72</sup>11 U.S.C. § 506(d)(1).

<sup>73</sup>*Id.* § 362. See Kennedy, *Automatic Stays Under the New Bankruptcy Law*, 12 U. MICH. J.L. REF. 1 (1978).

<sup>74</sup>Chandler Act, ch. 575, §§ 148, 428, 52 Stat. 840, 888, 918 (1930); see also *id.* § 507, 52 Stat. 927.

<sup>75</sup>See note 60 *supra*.

<sup>76</sup>11 U.S.C. § 362(d)-(f).

<sup>77</sup>*Id.* § 363(a)-(c).

<sup>78</sup>See Webster, *Collateral Control Decisions in Chapter Cases—Clear Rules v. Judicial Discretion*, 51 AM. BANKR. L.J. 197 (1977); Murphy, *Use of Collateral in Business Rehabilitations: A Suggested Redrafting of Section 7-203 of the Bankruptcy Reform Act*, 63 CALIF. L. REV. 1483 (1975).

<sup>79</sup>11 U.S.C. § 363(f). As pointed out at note 51, *supra*, the court's authority had been established by judge-made law, and section 363(f) may be viewed as a codification and clarification of the law applicable to such sales. Compare section 5-203(b) of the Bankruptcy Act of 1973 and the accompanying Note 2, H.R. Doc. No. 137, Part II, 93d Cong., 1st Sess. 191-92 (1973) (trustee may sell property free of liens without a hearing unless a dispute arises). Bankruptcy Rule 606(b)(3), not being inconsistent with the statutory provision, may appropriately govern the procedure in such a sale. See Kennedy, *An Adversary Proceeding Under the New Bankruptcy Rules, with Special Reference to a Sale Free of Liens*, 79 COM. L.J. 425 (1974). But compare proposed Bankruptcy Rule 6004(d), which was circulated to the bench and bar on March 1, 1982 for comment and which would eliminate any requirement for an adversary proceeding to obtain authority to sell property free of liens.

valid liens. Section 364, which authorizes the trustee or debtor in possession to obtain post-petition credit, explicitly accords to the court the power to grant a security interest to the post-petition creditor that is senior or equal to pre-petition liens. This power is subject to a showing at a hearing on notice that the credit is not otherwise obtainable and that the holder of any existing lien that is subordinated to or required to share equal priority with the newly granted security interest is afforded adequate protection.<sup>80</sup>

Section 510, which authorizes the court to subordinate one claim to another claim,<sup>81</sup> contemplates the possibility of subordination of a secured claim as well as an unsecured claim. The legislative intent in this respect is evident from the provision in subsection (c) of that section for the transfer of any subordinated lien to the estate.

### B. Avoidance of Liens

The new bankruptcy law enlarges the trustee's powers of avoidance at the expense of secured creditors. Thus the trustee's strong arm as a hypothetical lien creditor has been extended by endowing him with the status of a hypothetical bona fide purchaser of realty as against any creditor who failed to take available steps to perfect his lien against such a purchaser.<sup>82</sup> The same section negates the mischievous doctrine of some Bankruptcy Act cases that purported

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<sup>80</sup>Such authority was explicitly granted only in cases under sections 77 and 77B and Chapter X under prior law. 11 U.S.C. §§ 205(c)(3), 516(2) (1976) (repealed 1978). Section 344 authorized the issuance by a debtor in possession or receiver of certificates of indebtedness in a Chapter XI case, but no reference was made to the relative priority of such certificates. *Id.* § 744. See generally Banker, *Certificates of Indebtedness in Reorganization Proceedings: Analysis and Legislative Proposals*, 50 AM. BANKR. L.J. 1 (1976).

<sup>81</sup>11 U.S.C. §§ 510(a)-(c) (Supp. IV 1980). The subordination may simply enforce an agreement executed prior to the filing of the petition (§ 510(a)) or apply equitable principles recognized under prior law (§ 510(c)).

<sup>82</sup>*Id.* § 544(a)(3). Of course, the trustee may also prevail under this paragraph against an absolute transferee of the debtor's realty who had failed to perfect his interest by recordation or the taking of possession, but the most likely victim of the new weapon of the trustee is a mortgagee.

A new section declares a pre-petition security agreement purporting to cover property acquired by a debtor after the filing of the petition to be ineffective except as to proceeds, products, offspring, rents, or profits of property subject to a valid pre-petition security interest. 11 U.S.C. § 552. The invalidation of the after-acquired property clause follows what scant case authority there was under the Bankruptcy Act. See *In re Sequential Information Systems*, [1969-1973 Transfer Binder] SECURED TRANSACTIONS GUIDE (CCH) ¶ 51,749 (Bankr. S.D.N.Y. Dec. 15, 1970). An unsettling exception for the creditor having such a security interest allows the bankruptcy court, after notice and a hearing, to modify the creditor's lien in proceeds, products, offspring, rents, or profits "based on the equities of the case." 11 U.S.C. § 552(b).

to authorize a trustee to be subrogated to the position of any lienor, irrespective of the validity of his lien or of the amount of his lien, to defeat any junior lien.<sup>83</sup>

The most significant changes in the avoidance sections, so far as a secured creditor is concerned, are found in section 547, the new preference section. The period of vulnerability of a preferential transfer is reduced to ninety days unless the preferred creditor is an insider;<sup>84</sup> a preference to an insider remains voidable for a year. The cutback on the reach of the trustee's avoiding power when no insider is involved is countered by an elimination of the requirement that the creditor have had reasonable cause to believe that the debtor was insolvent at the time of the transfer and by the creation of a presumption that the debtor was then insolvent.<sup>85</sup> These aids are available, however, only when the trustee is attacking a preferential transfer made within the ninety-day period preceding bankruptcy. A transfer cannot occur for the purposes of the preference section before the debtor had an interest in the collateral;<sup>86</sup> therefore, the potential for a creditor to insulate his after-acquired collateral from attack by filing a financing statement before its acquisition is significantly diminished.<sup>87</sup> On the other hand, the floating lien of a lender secured by inventory or accounts receivable is afforded protection when the lienor is fully secured at the beginning of the period of vulnerability of a preference or when the lienor did not improve his position during the period.<sup>88</sup>

The section dealing with setoff likewise contains a new provision enabling the trustee to avoid a pre-petition setoff to the extent the

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<sup>83</sup>11 U.S.C. § 544(b). The doctrine nullified by the revised subsection was criticized by Kennedy, *The Trustee in Bankruptcy as a Secured Creditor Under the Uniform Commercial Code*, 65 MICH. L. REV. 1419 (1967), and supported by Countryman, *The Use of State Law in Bankruptcy Cases* (Part II), 47 N.Y.U. L. REV. 631, 657-61 (1972).

<sup>84</sup>11 U.S.C. § 547(b)(4). An "insider" is defined in § 101(25) to include 18 categories of persons.

<sup>85</sup>See *id.* § 547(f). The presumption of insolvency is intended to be rebuttable. H.R. REP. NO. 595, *supra* note 19, at 375, [1978] U.S. CODE CONG. & AD. NEWS at 6331; S. REP. NO. 989, 95th Cong., 2d Sess. 89 (1978), *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS 5787, 5875.

<sup>86</sup>11 U.S.C. § 547(e)(3).

<sup>87</sup>The Code, therefore, overrules the cases cited *supra* note 48.

<sup>88</sup>11 U.S.C. § 547(c)(5). This paragraph, embodying a recommendation of a committee of the National Bankruptcy Conference, was a reconciliation of the view favoring full recognition in bankruptcy of a floating lien on after-acquired collateral and the position that all security interests arising in collateral proceedings acquired by a debtor during the four-month period preceding bankruptcy should be avoided as preferential. See H.R. REP. NO. 595, *supra* note 19, at 179, 204-19, [1978] U.S. CODE CONG. & AD. NEWS at 6164-79. For a captious view of section 547(c)(5), see Eisenberg, *Bankruptcy Law in Perspective*, 28 U.C.L.A. L. REV. 953, 959-71 (1981).

creditor was able thereby to improve the position he held vis-à-vis the debtor ninety days before the filing of the petition.<sup>89</sup> The same section retains the features of the law of setoff under the Bankruptcy Act, including the disallowance of setoff of a claim acquired during the debtor's insolvency on the eve of or after the filing of the petition.<sup>90</sup> Similar treatment is provided for a debt incurred by a creditor during the debtor's insolvency and the ninety-day period before the filing of the petition for the purpose of effecting a setoff.<sup>91</sup>

The effort to codify the doctrine of *Dean v. Davis*,<sup>92</sup> which invalidated a security interest given for the purpose of enabling the debtor to prefer other creditors, was terminated by omission of any provision in the new law purporting to deal with this situation. The attempted solution in the Bankruptcy Act had caused too many problems for debtors and potential lenders and purchasers dealing with debtors in good faith to warrant its retention.<sup>93</sup>

The Bankruptcy Reform Act extends the right of a debtor to avoid liens against exempt property far beyond anything found in prior bankruptcy law. The Chandler Act had codified a Supreme Court ruling that allowed a debtor to avoid a judicial lien obtained against exempt property during the debtor's insolvency and within four months of his bankruptcy.<sup>94</sup> The new law enables the debtor to avoid any judicial lien that impairs his exemption, without regard to when it was obtained or the solvency of the debtor at the time of its attachment.<sup>95</sup> Moreover, the debtor is authorized to avoid any non-possessory non-purchase-money security interest impairing his exemption in tangible personal property of practically any kind except an automobile.<sup>96</sup> The premise of this provision is that because of the

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<sup>89</sup>11 U.S.C. § 553(b). The application of this test only to pre-petition setoffs is intended to deter them in the interest of enhancing the chances that debtors in distress may survive financial crises as a result of the exercise of restraint by their bank creditors.

<sup>90</sup>*Id.* § 553(a)(2). This provision is derived from section 68b(2) of the Bankruptcy Act. See Bankruptcy Act of 1898, ch. 541, § 68b(2), 30 Stat. 544, 565.

<sup>91</sup>11 U.S.C. § 553(a)(3). This provision codifies a limitation on setoff recognized by prior case law. See, e.g., *Cusick v. Second Nat. Bank*, 115 F.2d 150 (D.C. Cir. 1940); cf. *Katz v. First Nat'l Bank*, 568 F.2d 964 (2d Cir. 1977).

<sup>92</sup>See note 45 *supra*.

<sup>93</sup>H.R. Doc. No. 137, Part II, 93d Cong., 1st Sess. 177 (1973).

<sup>94</sup>Chandler Act ch. 575, § 67a(4), 52 Stat. 840, 876 (1938) (repealed 1978) (codifying *Chicago, Burlington & Quincy Ry. v. Hall*, 229 U.S. 511 (1913)). See 4 COLLIER ON BANKRUPTCY ¶ 67.15[2] (14th ed. W. Moore 1978).

<sup>95</sup>11 U.S.C. § 522(f)(1).

<sup>96</sup>*Id.* § 522(f)(2). The constitutionality of this provision and that cited in the preceding footnote has been widely attacked with diverse results. The attacks have been predicated primarily on the fifth amendment and do not raise any serious question as to the prospective constitutionality of an application to liens that arose after the effective date of the Bankruptcy Reform Act. Compare Note, *Constitutionality of*

minimal value of the collateral for the purposes of a forced sale, such a lien does not serve the purpose of enabling the creditor to realize his claim by foreclosing his security interest. Because of the debtor's need for the property and its high replacement cost, however, the creditor's right to seize and sell the property invests him with coercive debt-collecting power that is incompatible with the fresh-start policy of the Bankruptcy Act. That, at any rate, is the rationale for giving the debtor for the first time the right under the bankruptcy laws to avoid a security interest for his own benefit. Section 522, the exemption section, also recognizes that the debtor may avoid any lien against exempt property for his own benefit that was not created by a voluntary transfer and was not avoided by the trustee.<sup>97</sup> Even if the trustee avoids a lien, the debtor may claim an exemption in property recovered by the trustee if the property had not been voluntarily transferred or concealed by the debtor.<sup>98</sup>

### C. *Liens in Rehabilitation Cases*

The Bankruptcy Reform Act consolidates provisions that deal with rehabilitation as distinguished from liquidation. Reorganization of corporations, partnerships, and individually owned enterprises may be effected under Chapter 11,<sup>99</sup> and secured claims as well as unsecured claims may be dealt with in a plan proposed and confirmed under that chapter.<sup>100</sup> An official creditors' committee appointed in a Chapter 11 case, like an official creditors' committee elected under Chapter XI of the Bankruptcy Act,<sup>101</sup> can represent only the unsecured creditors,<sup>102</sup> but there is authority for the appointment of additional committees, including one or more commit-

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*Retroactive Lien Avoidance Under the Bankruptcy Code Section 522(f)*, 91 HARV. L. REV. 1616 (1981) (arguing against constitutionality) with Note, *Lien Avoidance Under Section 522(f) of the Bankruptcy Code: Is Retrospective Application Constitutional?*, 49 FORDHAM L. REV. 615 (1981) (upholding constitutionality) and 27 WAYNE L. REV. 1281 (1981) (upholding constitutionality).

<sup>97</sup>11 U.S.C. § 522(h).

<sup>98</sup>*Id.* § 522(g).

<sup>99</sup>Chapter 11 is a consolidation of Chapters VIII, X, XI, and XII of the Bankruptcy Act. H.R. REP. NO. 595, *supra* note 19, at 220-24, 242-54, [1978] U.S. CODE CONG. & AD. NEWS at 6179-84, 6201-13.

<sup>100</sup>11 U.S.C. § 1123(b)(1). A plan may also deal with any class of equity interests.

<sup>101</sup>11 U.S.C. § 738 (1976) (Bankruptcy Act § 338) (repealed 1978); Bankr. R. 11-27, *id.* app.; While Chapter X of the Bankruptcy Act provided for creditors' committees, there was no official creditors' committee in a Chapter X case. *See id.* §§ 609-613 (Bankruptcy Act §§ 209-213); Bankr. R. 10-211, *id.* app.

<sup>102</sup>11 U.S.C. §§ 1102(a)(1), 151102(a) (Supp. IV 1980). A creditors' committee may be elected in a Chapter 7 case pursuant to section 705(a), and as in a Chapter 11 case the committee members must be holders of unsecured claims.

tees for secured creditors.<sup>103</sup> A plan of reorganization under Chapter 11 may modify any secured debt with the consent of the creditor or of prescribed majorities of secured creditors in the same class.<sup>104</sup> If the plan leaves the secured creditor or a class of secured creditors unimpaired, acceptance is presumed without the necessity of any solicitation.<sup>105</sup> If the provisions of a plan affecting a secured debt are neither accepted nor deemed accepted, the court may nevertheless confirm a plan if it is found by the court to be "fair and equitable" and does not "discriminate unfairly."<sup>106</sup> The standard of "fair and equitable" is satisfied with respect to secured claims if the plan provides as follows:

(i) (I) that the holders of such claims retain the lien securing such claims, whether the property subject to such lien is retained by the debtor or transferred to another entity, to the extent of the allowed amount of such claims; and

(II) that each holder of a claim of such class receive on account of such claim deferred cash payments totalling at least the allowed amount of such claim, of a value, as of the effective date of the plan, of at least the value of such holder's interest in the estate's interest in such property;

(ii) for the sale, subject to section 363(k) of this title, of any property that is subject to the lien securing such claims, free and clear of such lien, with such lien to attach to the proceeds of such sale, and the treatment of such lien on proceeds under clause (i) or (iii) of this subparagraph; or

(iii) for the realization by such holders of the indubitable equivalent of such claims.<sup>107</sup>

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<sup>103</sup>*Id.* §§ 1102(a)(2), 151102(b).

<sup>104</sup>*Id.* §§ 1122, 1126(a)-(c), 1129(a). Because all claims in a particular class must be substantially similar to each other (§ 1124(a)), each holder of a secured claim is ordinarily in a separate class. A single class of multiple holders of secured claims may be appropriate when they are (1) lienholders secured under a common indenture or mortgage, (2) banks participating in large loans secured by common collateral, or (3) holders of mechanics' liens having equal priority in respect to common property. D. EPSTEIN & M. SHEINFELD, *BUSINESS REORGANIZATION UNDER THE BANKRUPTCY CODE: TEACHING MATERIALS* 172 (1979).

<sup>105</sup>11 U.S.C. § 1126(f). A claim is unimpaired if the plan (1) leaves the creditor's rights unaltered; (2) cures any pre-petition default that entitled the creditor to accelerate the maturity of the debt and reinstates the original maturity date; or (3) provides for cash payment of the allowed amount of the claim on the effective date of the plan. *Id.* § 1124.

<sup>106</sup>*Id.* § 1129(b).

<sup>107</sup>*Id.* § 1129(b)(2)(A). This provision is derived from the cramdown provisions of Chapters X and XII of the Bankruptcy Act. See notes 54 & 59 *supra*. The reference in subparagraph(A)(iii) to the "indubitable equivalent" was derived from *In re Murel*

At a late stage in the legislative process Congress was persuaded to provide specialized relief for the holders of secured claims against property without recourse against their debtors for personal liability beyond that afforded by their collateral. The concern arose particularly out of the confirmation of plans under Chapter XII of the Bankruptcy Act which allowed the retention by partnership debtors of the property securing nonrecourse indebtedness on payment to the creditors of the appraised value of the property.<sup>108</sup> Relief was provided in section 1111(b) by giving a nonrecourse creditor in a Chapter 11 case an allowable claim as if he had recourse, but the relief was unavailable if the property was disposed of at a sale where the nonrecourse creditor could bid.<sup>109</sup> Both recourse and nonrecourse creditors are given an option under section 1111(b)(2) to waive their unsecured claims and to become secured creditors in the full amount of their claims without regard to the value of their collateral.<sup>110</sup> Creditors exercising that option are permitted to retain their liens until the full amount of their claims has been paid, but the present value of the payments need not exceed the value of their collateral.<sup>111</sup> The option is intended to enable secured creditors to realize the benefit accruing from a post-confirmation appreciation of value of their collateral.

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Holding Corp., 75 F.2d 941 (2d Cir. 1935) (involving cramdown under former section 77B). 124 CONG. REC. 32,407 (1978) (statement of Congressman Edwards); *id.* at 34,007 (statement of Senator DeConcini).

<sup>108</sup>See COLLIER (15th ed.), *supra* note 18, ¶ 1111.02[1].

<sup>109</sup>11 U.S.C. § 1111(b)(1)(A)(ii). The recourse creditor retains his right of recourse whether or not the property is sold, provided he does not opt for the section 1111(b)(2) election discussed in the next sentence in the text.

<sup>110</sup>*Id.* § 1111(b)(2). This option is not available, however, if the interest of the creditor in collateral of the debtor is of inconsequential value. *Id.* § 1111(b)(1)(B)(i). Moreover, a recourse creditor may not choose the § 1111(b)(2) option if the property is sold. It is not clear why sale should deprive only the recourse creditor of the option. Under section 1111(b)(1)(A)(ii) the sale, however, had the effect of eliminating the status of the nonrecourse creditor as a recourse creditor. Arguably, therefore, the nonrecourse creditor is likewise barred from the section 1111(b)(2) election by the sale. See Pachulski, *The Cram Down and Valuation Under Chapter 11 of the Bankruptcy Code*, 58 N.C.L. REV. 925, 948 n.100 (1980).

By virtue of their waiver of unsecured deficiency claims, creditors who choose the section 1111(b)(2) option are not entitled to application of the "best interest of creditors" test of section 1129(a)(7)(A)(ii). This provision assures to each creditor a distribution at least equal to what he would receive on liquidation under Chapter 7. His acceptance of a position as a secured creditor without regard to the value of the collateral disentitles him to any expectation of any distribution as an unsecured creditor. 124 CONG. REC. 32,408 (1978) (Congressman Edwards' statement); *id.* at 34,007-08 (Senator DeConcini's statement).

<sup>111</sup>124 CONG. REC. 32,407 (1978) (Congressman Edwards' statement); *id.* at 34,007 (Senator DeConcini's statement).

Chapter 11 retains special legislation protective of the interests of financiers of certain transportation equipment.<sup>112</sup> The legislation is intended to permit the possession of such equipment to be taken by the holder of a purchase-money security interest in such equipment within a prescribed period after default, and neither the automatic stay nor the injunctive power of the bankruptcy court can save the equipment from the reach of the creditor.<sup>113</sup>

Chapter 13 of the Bankruptcy Reform Act is the successor to Chapter XIII of the Bankruptcy Act, but it contains significant reforms that affect secured creditors. While Chapter XIII afforded relief only to wage earners and similarly employed or compensated debtors,<sup>114</sup> Chapter 13 is available to any individual with regular income, including a self-employed debtor engaged in business.<sup>115</sup> There are limitations on eligibility with respect to the size of the debtor's secured and unsecured indebtedness,<sup>116</sup> but the effect is to substantially increase the number of persons eligible for relief under this chapter.

Another significant extension of the scope of the chapter is its authorization for the adjustment of both secured and unsecured debt without the consent of the creditors.<sup>117</sup> A plan may not reduce or extend a claim secured only by the debtor's residential real estate,<sup>118</sup>

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<sup>112</sup>11 U.S.C. §§ 1110, 1168. Section 1110 relates to "aircraft, aircraft engines, propellers, appliances, or spare parts" and "vessels of the United States." Section 1168 relates to "rolling stock equipment or accessories used on such equipment, including superstructures and racks" and applies only in railroad reorganizations under Chapter 11.

<sup>113</sup>The rationale for these exceptions is set out in H.R. REP. NO. 595, *supra* note 19, at 238-41, 405, 423, [1978] U.S. CODE CONG. & AD. NEWS at 6197-201, 6361, 6379; S. REP. NO. 989, *supra* note 85, at 117, 136, [1978] U.S. CODE CONG. & AD. NEWS at 5903, 5922; 124 CONG. REC. 32,396-97 (1978) (statement of Congressman Edwards); *id.* at 34,005 (statement of Senator DeConcini). As therein explained, the new legislation is intended to qualify the absolute right of a financier of transportation equipment conferred by provisions of the Bankruptcy Act to seize such equipment upon default. That the legislation fails to conform to the legislative design, see Kennedy, *Automatic Stays Under the New Bankruptcy Law*, 12 U. MICH. J.L. REF. 1, 35-37 (1978).

<sup>114</sup>11 U.S.C. § 1006(8) (1976) (repealed 1978) (Bankruptcy Act § 606(8)) ("whose principal income is derived from wages, salary or commissions").

<sup>115</sup>11 U.S.C. § 101(24) (Supp. IV 1980) ("whose income is sufficiently stable and regular to enable such individual to make payments under a plan under chapter 13 of this title, other than a stock broker or a commodity broker"); *id.* § 109(e).

<sup>116</sup>*Id.* § 109(e). The petitioning debtor must have "noncontingent, liquidated, unsecured debts of less than \$100,000 and noncontingent, liquidated secured debts of less than \$350,000" in order to be eligible. A joint petition may nevertheless be filed by an individual and his or her spouse, even though only one of them has regular income, but their aggregate indebtedness must meet the limitations mentioned in the first sentence.

<sup>117</sup>*Id.* §§ 1322, 1325.

<sup>118</sup>*Id.* § 1322(b)(2).

but if the debtor is in default in respect to such a debt, his plan may provide for the curing of the default within a reasonable time during the pendency of the case.<sup>119</sup> In the meantime, regular payments must be made on the secured debt. A plan may not provide for payments over a period exceeding three years, unless the court approves a longer period of up to five years.<sup>120</sup> The discharge obtainable under a Chapter 13 plan does not extend to debts on which the last payment is due after the final payment under the plan.

A Chapter 13 plan may be confirmed by the court without the consent of any creditor.<sup>121</sup> Secured creditors are protected by section 1325(a)(5), which entitles the holder of each secured claim that can be modified, to one of the following modes of treatment: (1) a provision that is accepted by the creditor; (2) retention of the creditor's lien and distribution of property of a present value as of the effective date of the plan not less than the allowed amount of the creditor's secured claim; or (3) surrender of the property securing the claim. The second alternative is the one most frequently chosen, and considerable litigation has been engendered respecting the proper mode of determining the present value of the claim.<sup>122</sup>

A Chapter 13 plan must provide each unsecured creditor at least as much as would have been paid on liquidation under Chapter 7,<sup>123</sup> but because many petitioning debtors have no nonexempt assets of any significant value, many plans have been proposed for confirma-

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<sup>119</sup>*Id.* § 1322(b)(5). Considerable litigation and diversity of judicial views have developed in respect to what constitutes a reasonable time under section 1322(b)(5). Compare *Coleman v. Brown (In re Coleman)*, 5 Bankr. 812 (W.D. Ky. 1980) (3 years not reasonable) with *In re Lynch*, 12 Bankr. 533 (W.D. Wis. 1981) (3 years held reasonable).

There has also developed a diversity of opinion as to whether, after acceleration of the maturity of mortgage indebtedness by a creditor on account of a pre-petition default, the option to cure the default remains available under section 1322(b)(5). Compare *In re Williams*, 11 Bankr. 504 (S.D. Tex. 1981) (default held not curable after the creditor had elected to accelerate maturity because of the default) with *Di Pierro v. Cullen (In re Toddeo)*, 9 Bankr. 299 (E.D.N.Y. 1981) (default allowed to be cured where Chapter 13 petition filed before entry of final judgment of foreclosure by state court; state law respecting effect of creditor's acceleration held not to be binding on the court in construing section 1322(b)(5)). See generally Beck, *The Plight of the Defaulting Mortgagor*, 15 IND. L. REV. 561 (1982).

<sup>120</sup>11 U.S.C. § 1322(c) (Supp. IV 1980).

<sup>121</sup>*Id.* § 1325(a), requiring the court to confirm a Chapter 13 plan if it meets six requirements specified in the subsection. Unlike sections 651 and 652 of the Bankruptcy Act, § 1325(a) of Title 11 does not require the consent of either secured or unsecured creditors.

<sup>122</sup>See Bowman & Thompson, *Secured Claims Under Section 1325(a)(5)(B): Collateral Valuation, Present Value, and Adequate Protection*, 15 IND. L. REV. 569 (1982); Comment, *Bankruptcy Reform Act of 1978: Chapter 13 Cramdown of the Secured Creditor*, 1981 WIS. L. REV. 333.

<sup>123</sup>11 U.S.C. § 1325(a)(4).

tion that provide only for payment of secured debts and no payment, or only minimal payment, of unsecured claims. At this juncture the numerous opinions of the courts considering such plans are in disarray as to whether they may be deemed to satisfy the standards of confirmation.<sup>124</sup>

Chapter 9 of the Bankruptcy Code provides for the adjustment of debts of a municipality,<sup>125</sup> defined to include any "political subdivision or public agency or instrumentality of a state."<sup>126</sup> The filing of a petition for relief under Chapter 9 triggers an automatic stay of the same scope as that provided by section 362 of Title 11, but in addition the stay operates against the enforcement of a "lien on or arising out of taxes or assessments owed to the debtor."<sup>127</sup> The provisions of Chapters 3, 5, and 11 that apply to holders of secured claims generally apply in Chapter 9 cases,<sup>128</sup> and their construction in Chapter 7 and particularly Chapter 11 cases may be assumed to be persuasive in Chapter 9 cases.

#### D. Discharge

Traditionally, discharge of a bankrupt has not barred the enforcement of a lien securing the debt.<sup>129</sup> The discharge has been viewed as affecting only the claim for a deficiency. Although an unfortunate phrase in section 524 has given rise to confusion in a few quarters,<sup>130</sup> the intention of Congress to leave the enforceability of a valid lien intact after discharge cannot be doubted.<sup>131</sup>

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<sup>124</sup>See LoPucki, "Encouraging" Repayment Under Chapter 13 of the Bankruptcy Code, 18 HARV. J. OF LEGIS. 347 (1981); Note, Chapter 13 De Minimis Plans: Toward a Consensus on "Good Faith," 9 HOFSTRA L. REV. 593 (1981); Note, "Good Faith" and Confirmation of Chapter 13 Composition Plans: Analysis and a Proposal, 65 MINN. L. REV. 659 (1981); Note, Abusing Chapter 13 of the Bankruptcy Code: The Problem of Nonrepayment, 55 N.Y.U.L. REV. 941 (1981); Comment, Good Faith in Chapter 13: A New Wild Card for Bankruptcy, 8 OHIO N.U.L. REV. 102 (1981); Note, Filing For Personal Bankruptcy: Adoption of a "Bona Fide Effort" Test Under Chapter 13, 14 U. MICH. J.L. REF. 321 (1981).

<sup>125</sup>11 U.S.C. §§ 109(c), 941, 943.

<sup>126</sup>*Id.* § 101(29).

<sup>127</sup>*Id.* § 922.

<sup>128</sup>See *id.* § 901.

<sup>129</sup>See Long v. Bullard, 117 U.S. 617 (1886).

<sup>130</sup>11 U.S.C. § 524(a): "A discharge . . . (2) operates as an injunction against the commencement . . . of an action, the employment of process, or any act, to collect . . . from property of the debtor." The court in *In re Williams*, 9 Bankr. 228 (D. Kan. 1981) held that the quoted language barred enforcement of a secured claim after discharge of the underlying debt.

<sup>131</sup>See H.R. REP. NO. 595, *supra* note 19, at 361, [1978] U.S. CODE CONG. & AD. NEWS at 5963; S. REP. NO. 989, *supra* note 85, at 76, [1978] U.S. CODE CONG. & AD. NEWS at 5787.

Only an individual is entitled to a discharge in a case under Chapter 7,<sup>132</sup> but the discharge obtainable by virtue of the confirmation of a Chapter 11 plan is comprehensive and practically absolute in the case of a corporate or partnership debtor.<sup>133</sup> An individual remains subject to the exceptions that apply in a Chapter 7 case,<sup>134</sup> but these are unlikely to be important so far as the enforcement of a secured claim is concerned. Thus a secured creditor is bound by the terms of a plan confirmed under Chapter 11, notwithstanding subsequent default in the performance of the executory features of the plan.

Confirmation of a Chapter 13 plan does not discharge the debtor. When the debtor completes all the payments under a confirmed Chapter 13 plan, however, the court ordinarily is required to discharge the debtor from all debts "provided for by the plan" except those for alimony, support, and maintenance and those not payable within the term of the plan.<sup>135</sup> Thus, any debt, whether secured or unsecured, that is not provided for by the plan survives the discharge granted under section 1528. Plans that omit any reference to a secured debt on the assumption that the debtor will maintain payments to the creditor subject the debtor to the risk that the underlying obligation remains unaffected by the discharge insofar as it becomes unsecured.<sup>136</sup> If the debtor does not complete payments under the plan, the court may nevertheless grant a limited discharge of the same scope as that obtainable in a Chapter 7 case if the debtor's failure to perform in full was due to circumstances for which the debtor is not justly accountable.<sup>137</sup> The effect of a discharge on a secured claim in a Chapter 13 case is not likely to be any different, whether it is a complete or limited discharge.

## V. CONCLUSION

What is the net effect of the Bankruptcy Reform Act on the rights of secured creditors? The new law has been criticized for the degree to which it authorizes the bankruptcy court to impair those rights.<sup>138</sup> On the other hand it has been criticized for its failure to

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<sup>132</sup>11 U.S.C. § 727(a)(1).

<sup>133</sup>*Id.* § 1141(d)(1).

<sup>134</sup>*Id.* § 1141(d)(2).

<sup>135</sup>*Id.* § 1328(a).

<sup>136</sup>See Countryman, *Letter to the Editor*, 85 Com. L.J. 28 (1980).

<sup>137</sup>11 U.S.C. § 1328(b), (c).

<sup>138</sup>See Eisenberg, *supra* note 88, at 955-71; Reisman, *The Challenge of the Proposed Bankruptcy Act to Accounts Receivable and Inventory Financing of Small-to-Medium-Sized Business*, 83 Com. L.J. 169, 174 (1978) ("[t]he proposed Bankruptcy Act would virtually negate the effectiveness of Article 9 security interests in bankruptcy proceedings . . .").

constrain secured creditors' rights sufficiently to assure a fuller measure of attainment of the objectives of bankruptcy law.<sup>139</sup> The survey undertaken in this Article has suggested that the principal effect of the new law on secured creditors is to particularize and thus to clarify the ways in which their rights have been affected.<sup>140</sup> Undoubtedly the most dramatic effect can be found in Chapter 11, which authorizes the confirmation of plans of reorganization that may impair secured creditors' rights. Most business reorganizations attempted and effected under the Bankruptcy Act did not directly affect secured creditors' rights at all, because Chapter XI, by far the most frequently invoked reorganization chapter, could deal only with unsecured debts. This limitation, however, constituted a serious drawback in the usefulness of the chapter as a vehicle for enabling debtors in distress to develop viable reorganization plans.

Although the new act for the first time explicitly authorizes the use and disposition of property subject to security interests during the pendency of a case, the relevant statutory provisions codify prior case law more than they modify it or establish new law. Moreover, the new act recognizes in numerous contexts the secured creditor's right to "adequate protection" when his rights are or may be affected by exercise of the powers granted the bankruptcy court. Automatic stays of the exercise of secured creditors' rights are more fully elaborated in the new act than they were in the prior act, but much of this elaboration provides new limitations on the scope and operation of the stays and new safeguards of the secured creditor's rights. Not surprisingly, given the objectives of bankruptcy legislation, the trustee's rights to avoid liens against the debtor's

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<sup>139</sup>See Gordanier, *The Indubitable Equivalent of Reclamation: Adequate Protection for Secured Creditors Under the Bankruptcy Code*, 54 AM. BANKR. L.J. 299, 299 (1980) ("[i]n facilitating business reorganizations, . . . the Code may prove to be no more successful than its predecessor, the Bankruptcy Act, and for the same reason: secured creditors have, practically speaking, a veto over many if not most of the plans proposed under chapter 11"); Note, *From Debtor's Shield to Creditor's Sword: Cram Down Under the Chandler Act and the Bankruptcy Reform Act*, 55 CHI-KENT L. REV. 713 (1979).

<sup>140</sup>This theme with variations is elaborated in Coogan, *The New Bankruptcy Code: The Death of Security Interest?*, 14 GA. L. REV. 153 (1980). See also Committee on Developments in Business Financing, *Structuring and Documenting Business Financing Transactions Under the Federal Bankruptcy Code of 1978*, 35 BUS. LAW. 1645 (1980); Del Gaudio, *Article 9 of the Uniform Commercial Code and the Bankruptcy Reform Act of 1978*, 12 U. TOL. L. REV. 305 (1981); Massari, *Adequate Protection Under the Bankruptcy Reform Act* in ANNUAL SURVEY OF BANKRUPTCY LAW—1979 at 171 (W. Norton ed. 1979); Poe, *Further Thoughts on Secured Creditors Under the New Bankruptcy Code*, 28 EMORY L.J. 649 (1979); Rome, *The New Bankruptcy Act and the Commercial Lender*, 96 BANKING L.J. 389 (1979); Shanor, *A New Deal for Secured Creditors in Bankruptcy*, 28 EMORY L.J. 587 (1979).

property have been extended, but there are also changes cutting in the other direction.

The wisdom and worth of the new law must be judged in the light of experience—how well it works in practice. When Congress conferred pervasive jurisdiction on the bankruptcy court over proceedings arising under Title 11 and proceedings arising in or related to cases under Title 11 of the United States Code,<sup>141</sup> it was sensitive to the need to remove bankruptcy judges from involvement in matters of administration.<sup>142</sup> A principal consideration in adopting this reform was to assure secured creditors that their controversies with the trustee as the representative of unsecured creditors would be heard and determined by an impartial tribunal free from the influence that derives from continual contact with the administration of a case. The separation of judicial from administrative functions is, however, more an expression of an aspiration than a reality in non-pilot districts, where there are no United States trustees to assume and exercise necessary administrative responsibilities.<sup>143</sup> Moreover, the future of the pilot project is now imperiled because of efforts under way in Washington to eliminate the United States trustee program as a budgetary item in the appropriation for the Department of Justice. Whether the proper balance is drawn between the rights of secured creditors and the rights of unsecured creditors and debtors depends crucially on the judgment and discretion exercised by the bankruptcy judges. Congress has entrusted them with more judicial authority and responsibility than was ever granted them under prior legislation. If the need for separate administrative personnel can be met, the new dispensation should significantly enhance the effectiveness and efficiency of the bankruptcy system in rehabilitating distressed debtors as economic units and in facilitating the faster and fuller payment of their debts, both secured and unsecured.

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<sup>141</sup>28 U.S.C. § 1471(b), (c) (Supp. III 1979).

<sup>142</sup>See 124 CONG. REC. 32,410 (1978) (statement of Congressman Edwards); *id.* at 32,391 (statements of Congressman Butler); *id.* at 34,010, 34,018 (statements of Senator DeConcini); H.R. REP. No. 595, *supra* note 19, at 101, 109-10, [1978] U.S. CODE CONG. & AD. NEWS at 6062, 6070-71

<sup>143</sup>United States trustees are authorized to be appointed and to serve only in 18 judicial districts. 11 U.S.C. § 1501 (Supp. IV 1980); 28 U.S.C. § 581 (Supp. III 1979).