The Unfortunate Life and Merciful Death of the Avoidance Powers Under Section 103 of the Durbin-Delahunt Bill: What Were They Thinking?, (with C. Mooney, Jr.).

Steven L. Harris, Chicago-Kent College of Law
THE UNFORTUNATE LIFE AND MERCIFUL DEATH OF THE AVOIDANCE POWERS UNDER SECTION 103 OF THE DURBIN-DELAHUNT BILL: WHAT WERE THEY THINKING?

Steven L. Harris & Charles W. Mooney, Jr.*

INTRODUCTION

This Article seeks to draw some lessons from the drafting, introduction, claimed justification, and eventual withdrawal of Section 103 of the Employee Abuse Prevention Act of 2002 (the “2002 Bill”).

The Bill was introduced by Senator Richard J. Durbin (D-Ill.) and Rep. William D. Delahunt (D-Mass.) on July 25, 2002. A week later the sponsors publicly announced its introduction by holding a joint press conference and issuing a joint press release. According to the sponsors, the Bill was designed to “curb abuses that deprive employees and retirees of their earnings and retirement savings when businesses collapse” and provide additional protections “from corporate practices that rob [employees and retirees] of their earnings and retirement savings.” The Bill, however, addressed much more than “abuses” and unsavory “corporate practices that rob” employees and retirees. Of particular relevance to this Symposium, section 103 of the Bill

* The authors are, respectively, Professor of Law, Chicago-Kent College of Law, and Professor of Law, University of Pennsylvania Law School. Citations to the Uniform Commercial Code (“UCC”), including Revised Article 9, are to the 2002 official text. Citations to Former Article 9 and Former UCC § 9-xxx are to the 1995 official text of the UCC. Except where contraindicated, citations to title 11 of the United States Code (“Bankruptcy Code”) are current to September 30, 2003.

3 Id.
5 On April 7, 2003, we presented an outline of this Article at a symposium conference.
("Section 103") would have expanded substantially a bankruptcy trustee’s power to avoid (set aside) a debtor’s prebankruptcy transfers of property, including transfers of security interests in personal property.6 By the beginning of the American Bar Association’s 2002 Annual Meeting in early August, many of the attendees specializing in the law of secured transactions and bankruptcy had become aware of the Bill’s introduction. Many of them had not read the Bill, however, and were surprised to learn of its breadth. The sponsors explained that Section 103 was a response to the recent enactment of revised Uniform Commercial Code ("UCC") Article 9.7 Section 103, they wrote, "restores to trustees in bankruptcy the ability to review and set aside suspect transactions which they enjoyed as lien creditors under Article 9 of the Uniform Commercial Code prior to the UCC amendments."8 However, a closer look at the text of Section 103 revealed that it would have done far more than restore the status quo ante. It would have empowered trustees in bankruptcy to set aside a multitude of routine secured transactions that have formed part of the financial landscape for decades, even before the Bankruptcy Code was first enacted.9

During the meeting a “rump” group of practicing lawyers and academics came together to discuss their opposition to the secured-transactions-related provisions of the Bill, including Section 103. In the days following the meeting a few more participants joined the group. The group made its chief order of business the preparation of a report that would explain the problems with the Bill and generate opposition to it.10

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6 Employee Abuse Prevention Act of 2002 (Durbin-Delahunt) § 103. The Bill contained several other provisions that would have gone well beyond addressing corporate abuses. One provision would have established a new class of administrative expenses and afforded these expenses a “super” priority over secured claims. See id. § 203. Another provision would have established a new, vague, federal bankruptcy-law test for recharacterizing a prebankruptcy sale, lease, or other transfer of property as a secured loan. The new test would have replaced the generally applicable and settled state-law tests. See id. § 102. By addressing only Section 103 of the Bill in this Article, we do not intend to suggest our endorsement of the other secured-transaction-related provisions of the Bill.


8 Summary, supra note 4; see also Press Release, supra note 2 ("[Section 1003] restores to bankruptcy trustees the full authority to challenge and set aside pre-bankruptcy transactions that take assets out of the company.").

9 The Bankruptcy Code was enacted in 1978, at which time Article 9 had been in effect in every state (except Louisiana) for at least a decade. Bankruptcy Reform Act of 1978, Pub. L. No. 96-598, 92 Stat. 2549 (1978); Uniform Commercial Code Reporting Service, supra note 7.

10 Professor Mooney took the lead in organizing the group during the ABA meetings, and both of us participated in the preparation of the Report. See infra note 12.
The group’s appreciation of the need to act quickly increased substantially when, in late August, Senator Patrick J. Leahy (D-Vt.), then Chairman of the Senate Judiciary Committee, scheduled a hearing before the full Committee for Thursday, September 5, 2002, during the first week following the end of the summer recess.\textsuperscript{11} By the end of August, the thirteen members of the group had produced a 26-page report ("Report").\textsuperscript{12} The Report offered a trenchant critique of several aspects of the Bill, including Section 103. By September 3, the day after Labor Day, the group had circulated the report electronically to thousands of lawyers and clients.

While the group was working on the Report, many interested persons engaged in an ongoing and active discussion of the Bill. Some of the discussions took place with lawyers in the office of the counsel to Senator Orin G. Hatch (R-Utah), then the ranking minority member of the Judiciary Committee, and with counsel for the Senate sponsors. Several interested organizations expressed to the sponsors their strong opposition to several of the Bill’s provisions, including Section 103. These included organizations as diverse as The Depository Trust and Clearing Corporation and The Options Clearing Corporation (writing jointly),\textsuperscript{13} The Bond Market Association,\textsuperscript{14} and the National Conference of Commissioners on Uniform State Laws ("NCCUSL"). By the end of the day on September 3, 2002, the Senate sponsors had thrown in the towel. The hearing before the full Judiciary Committee, scheduled for September 5, was cancelled.\textsuperscript{16}

From that time on, it was clear that the Bill as it then existed was doomed. Revised versions of some of the Bill’s provisions subsequently surfaced, but the final nail in the Bill’s coffin was a joint

\begin{footnotes}
\footnotetext{13}{Letter from The Depository Trust and Clearing Corporation and The Options Clearing Corporation to The Honorable Richard Durbin (Aug. 30, 2002) (on file with authors).}
\footnotetext{14}{Letter from The Bond Market Association to The Honorable Richard Durbin (Aug. 20, 2002) (on file with authors).}
\footnotetext{15}{Letter from NCCUSL to Senator Richard Durbin (Aug. 30, 2002) (on file with authors).}
\footnotetext{16}{Notice of Full Committee Hearing Postponement (Sept. 3, 2002), available at http://www.senate.gov/~judiciary/hearing.cfm?id=395. This development was personally disappointing to one of us (Mooney), who was scheduled to testify as a witness for the minority at the September 5 hearing.}
\end{footnotes}
letter voicing the strong objections of the Secretary of the Treasury and the Chairs of the Securities and Exchange Commission, the Commodity Futures Trading Commission, and the Board of Governors of the Federal Reserve System. They wrote, in part:

[T]he proposed legislation risks creating substantial uncertainty regarding the enforceability of a wide range of secured transactions and financial instruments that play a crucial role in the U.S. capital markets or otherwise facilitate risk management. As a result financial markets would be less efficient—borrowers would face higher costs of credit and investors would receive lower returns as intermediaries were forced to charge larger fees to compensate for the greater risk and uncertainty.

Accordingly, we ask that you eliminate those provisions in the Employee Abuse Prevention Act that threaten the operation of the U.S. financial markets.

Part I of this article examines the sponsors’ claim that Section 103 addresses abusive corporate practices by restoring to trustees in bankruptcy the avoidance powers they enjoyed before UCC Article 9 was revised. We conclude that the claim does not ring true. The changes wrought by Revised Article 9 do not deprive lien creditors (or bankruptcy trustees) of the power to set aside abusive or even suspect transactions. Nor are the effects of Section 103 limited to restoring the pre-2001 regime with respect to a distinct class of secured transactions, abusive or otherwise. The proposed avoidance powers in the Bill go far beyond negating the recent revisions to Article 9. By rendering many routine secured transactions ineffective in bankruptcy, the proposed

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18 Letter from Paul H. O’Neill et al., supra note 17, at 2. The Report, which had been made available to these organizations, reached similar conclusions:

These two sets of provisions [sections 103 and 203] would significantly impair in bankruptcy many nonpossessory and possessory security interests in personal property. These changes would effectively repeal, immediately and retroactively, much of Uniform Commercial Code (“UCC”) Article 9, thus relegate secured transactions law in the United States to the genre of legal regimes that exist in many developing countries, with the corresponding impediments to financing and capital formation. This repeal would come not long after all 50 states, the District of Columbia, and the U.S. Virgin Islands adopted changes to UCC Article 9 intended to modernize the statute to facilitate the capital formation that is so crucial to the health of our national economy. Indeed, the sponsors indicate that the expanded avoidance powers in the Bill are specifically intended to override certain of these changes to UCC Article 9. The proposed avoidance powers in the Bill go far beyond negating the recent changes made to UCC Article 9. They would render UCC Article 9 largely without effect to support extensions of secured credit because many secured transactions would not be effective in bankruptcy.

REPORT, supra note 12, at 5 (footnote omitted).
avoidance powers would render Article 9 largely without effect to support extensions of secured credit.

Part II examines the startling contrast between the narrow, stated purpose of Section 103 and the section's potentially devastating effects. We assume first that, for whatever reason, Section 103 imperfectly reflects the sponsors' limited objective and consider whether there is any principled support for that objective or for the broader objective of protecting employees and retirees. We conclude that none exists. Then we assume that the text of Section 103 reflects other, unstated principles and consider whether those principles reflect sound bankruptcy policy. Here again, we conclude that they do not. Part III draws some lessons from the legislative process surrounding Section 103, and is followed with a brief conclusion.

I. THE MISMATCH BETWEEN SECTION 103 AND THE SPONSORS' EXPLANATION OF IT

Section 103(a) of the Bill would have expanded two of the bankruptcy trustee's powers to avoid prebankruptcy transfers, including the transfer (creation) of security interests in personal property: the "strong-arm" power in Bankruptcy Code § 544(a)\(^{19}\) and the power to avoid preferences in Bankruptcy Code § 547.\(^{20}\) We discuss these in turn.

A. The Trustee's "Strong-arm" Avoidance Power—Bankruptcy Code Section 544(a)

Bankruptcy Code § 544(a) arms the trustee with the rights and powers of a hypothetical judicial lien creditor.\(^{21}\) Because the rights of a judicial lien creditor are senior to an unperfected security interest in personal property under UCC Article 9,\(^{22}\) § 544(a) generally empowers a trustee in bankruptcy to avoid security interests that are unperfected when the debtor enters bankruptcy.\(^{23}\)

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\(^{19}\) See 11 U.S.C. § 544(a)(1).

\(^{20}\) Id. § 547.

\(^{21}\) See id. § 544(a)(1). Section 544(a) also arms a trustee with the rights and powers of a hypothetical creditor who obtains an execution that is returned unsatisfied, see id. § 544(a)(2), and a hypothetical bona fide purchaser of real property, other than fixtures. See id. § 544(a)(3). We discuss the latter provision infra Part II.C.2.

\(^{22}\) U.C.C. § 9-317(a)(2).

\(^{23}\) There are some exceptions. See, e.g., U.C.C. § 9-317(e) (purchase-money security interest perfected within twenty days following delivery of collateral to debtor takes priority over an intervening (i.e., while the security interest was unperfected) buyer, lessee or lien creditor); 11
Section 103(a) of the Bill would have revised Bankruptcy Code § 544(a) by adding to a trustee's arsenal the rights and powers of a hypothetical good-faith purchaser of property who gave value, relied on incorrect information in a public record, and either (i) took possession of the property (even if the property was not of a type that in fact could be possessed) or (ii) took steps to make the purchaser's interest invulnerable to a judicial lien creditor.24 The trustee would have enjoyed these new rights and powers even if no such actual purchaser existed and even if no incorrect information regarding the challenged transfer actually existed in a public record.

Some examples will help explain the huge, adverse effect Section 103(a) would have had on routine secured transactions.25 Consider first a typical secured financing in which Dealer (say, a car dealer) obtains needed capital by borrowing funds from Lender and granting to Lender a security interest in Dealer's existing and future inventory of new automobiles, together with all receivables arising out of sales or leases of the inventory, including installment sale contracts and leases. Normally, Lender would perfect its security interest by filing a financing statement covering the inventory and receivables. Because Lender's perfected-by-filing security interest is invulnerable to a subsequent judicial lien creditor, Dealer's bankruptcy trustee cannot avoid it under § 544(a)(1).26 Section 103(a) would have reversed the result. It would have provided the trustee with the rights of a hypothetical "buyer in ordinary course of business" of the inventory, who, under UCC Article 9, would take free of Lender's perfected security interest.27 The trustee also would have enjoyed the rights of a hypothetical ordinary-course purchaser of the installment sale contracts and leases ("chattel paper") arising from Dealer's sale or lease of its inventory, who takes possession of the chattel paper and gives new value. Because such a purchaser would take free of Lender's perfected security interest under UCC Article 9,29 Dealer's trustee's new rights as

U.S.C. § 546(b) (prohibiting avoidance under § 544 when a generally applicable law, such as U.C.C. § 9-317(e), permits later perfection to achieve priority over intervening claimant, even though an interest in property is not perfected at the time the bankruptcy petition is filed).

24 Employee Abuse Prevention Act of 2002 (Durbin-Delahunt), S. 2798, H.R. 5221, 107th Cong. § 103(a).

25 Readers who are interested in a more detailed critique of Section 103 should consult the Appendix.


27 See U.C.C. §§ 9-320(a) (rights of buyer in ordinary course); 1-201(9) (defining "buyer in ordinary course").

28 See UCC § 9-102(a)(11), defining "chattel paper" in part as:

a record or records that evidence both a monetary obligation and a security interest in specific goods, a security interest in specific goods and software used in the goods, a security interest in specific goods and license of software used in the goods, a lease of specific goods, or a lease of specific goods and license of software used in the goods.

29 See id. § 9-330(a), (b) (certain purchasers of chattel paper in the ordinary course of
a hypothetical good-faith purchaser would have enabled the trustee to avoid Lender’s perfected security interest in the chattel paper. In short, Section 103(a) would have turned a typical secured creditor, to whom the Bankruptcy Code normally awards the value of its collateral, into an unsecured creditor, who shares pro rata in unencumbered assets. This result would have obtained even if (i) Lender and Dealer had acted in good faith and bargained at arm’s length, (ii) Lender had perfected its security interest by filing a financing statement in the proper filing office, and (iii) the information in the filed financing statement had been complete and in all respects correct.

How could a lender protect its security interest against its debtor’s future bankruptcy if Section 103(a) were in effect? Arguably the lender’s taking physical possession of the inventory and chattel paper would provide protection, inasmuch as the lender’s actual possession might override a trustee’s hypothetical possession. But, as the Report observed, taking possession of the collateral “would be practically impossible in the case of most inventory financing and . . . often is not practical in the case of chattel paper.” On the other hand, the trustee’s hypothetical possession might be read, quite plausibly, to override (or substitute for) the lender’s actual possession. Under this reading, even the lender’s actual possession of the inventory and chattel paper would not protect its security interests from avoidance.

Now consider the application of the expanded strong-arm avoidance power to a perfected security interest in equipment. Unlike the case of inventory and chattel paper, Article 9 provides no broad good-faith purchaser protection for purchasers of equipment encumbered by a perfected security interest. Even so, Section 103(a) would have empowered trustees to avoid the perfected security interest. It would have conferred on a trustee hypothetical reliance on business who take possession of the chattel paper may obtain priority over security interests perfected by a method other than perfection).

See Employee Abuse Prevention Act of 2002 (Durbin-Delahunt), S. 2798, H.R. 5221, 107th Cong. § 103. As the Report noted:

In like manner, [Section 103] also would permit avoidance of security interests perfected by filing in instruments (such as promissory notes), documents of title, and securities. U.C.C. §§ 9-330; 9-331. Note that most of the good faith purchase rules discussed in this section (UCC §§ 9-320, 9-330, and 9-331) had very similar antecedents that would have produced identical results under former (i.e., pre-revision) UCC Article 9. See Former U.C.C §§ 9-307; 9-308; 9-309.

REPORT, supra note 12, at 6 n.7.

Id. at 6.

The Report explained further:

The same reasoning might be applied to [a] secured party that has “control” of intangible assets such as uncertificated securities or security entitlements, even if actual possession were impossible. . . On this reasoning even security interests perfected by possession or control would be vulnerable in bankruptcy.

Id.
hypothetical incorrect information in the filing office. Under UCC section 9-338(2), a purchaser who relies on certain incorrect information in a financing statement takes free of a security interest perfected by that financing statement. Even if Section 103(a) is construed narrowly, to apply only to cases where a good-faith purchaser’s rights depend on its having relied on incorrect information (and not, for example, to cases where a good-faith purchaser prevails solely because of its status as a good-faith purchaser), it would have permitted trustees to avoid perfected-by-filing security interests in equipment—and virtually all other security interests perfected by filing.

B. The Trustee’s Power to Avoid Preferences—Bankruptcy Code
Section 547

Section 103 of the Bill would have expanded not only a trustee’s “strong-arm” power under Bankruptcy Code § 544(a) but also the power to avoid preferences under § 547. Section 547 generally empowers the trustee to avoid, as a preference, a transfer of property (including the creation of a security interest) made by an insolvent debtor to a non-insider creditor within 90 days before a bankruptcy filing if the transfer is on account of an antecedent debt. One cannot determine whether a transfer occurred during the 90-day period or was made on account of an antecedent debt without first determining when the transfer was made. Bankruptcy Code § 547(e) addresses this timing issue in a somewhat complicated fashion. In general, the timing of a transfer turns on whether and when a transfer is “perfected,” as the term is used in § 547. A security interest or other transfer that is not “perfected” for the purpose of preference avoidance usually can be avoided. This is because a transfer that is “not perfected before the later of (i) the commencement of the case; or (ii) 10 days after such transfer takes effect between” the parties is deemed to have been made “immediately before the filing of the [bankruptcy] petition.” A transfer made immediately before the petition is filed would have been made within the 90-day period and for an antecedent debt, thereby satisfying two significant elements of an avoidable preference.

Section 547 currently provides that a transfer of personal property

33 See U.C.C. § 9-338(2).
34 See REPORT, supra note 12, at 7 (discussing this limited reading).
36 See id. § 547(e)(2)(B). Bankruptcy Code § 547(e)(2)(A) makes an exception. The transfer occurs at the time it becomes effective between the parties if the transfer is perfected no more than ten days after that time.
37 Id. § 547(e)(2)(C).
or fixtures is perfected when it becomes invulnerable to a judicial lien obtained by a creditor on a simple contract.\textsuperscript{38} A security interest that is perfected under UCC Article 9 meets this test; a security interest that is unperfected under UCC Article 9 does not.\textsuperscript{39} By replacing the judicial lien creditor test with a good-faith purchaser test, Section 103(b) of the Bill would have significantly affected the time when allegedly preferential transfers occur.\textsuperscript{40} Under Section 103(b), a security interest would not be "perfected" for the purpose of preference avoidance even if the security interest was "perfected" under UCC Article 9,\textsuperscript{41} as long as the security interest could have been subordinated to, or cut off by, a claim of a good-faith purchaser. Thus, in most cases the security interests in inventory, chattel paper, and equipment discussed above in connection with strong-arm avoidance also would be avoidable as preferences under Section 103(b) because those security interests are vulnerable to hypothetical good-faith purchasers who relied on hypothetical incorrect information in the public record.

There are other security interests that would be exposed to preference avoidance were the judicial lien creditor test replaced by a good-faith purchaser test. Consider a consumer buyer of consumer goods from another consumer.\textsuperscript{42} Such a buyer normally cuts off a purchase-money security interest in the goods if the secured party has relied on automatic perfection\textsuperscript{43} and has not filed a financing statement.\textsuperscript{44} Being vulnerable to the rights of an innocent purchaser, the perfected security interest would not have been "perfected" under Section 103(b) and thus would have been vulnerable to preference avoidance. As the Report explained, "The Act would instantly change the cost/benefit analysis by forcing the [purchase-money] secured party to go the trouble and expense of filing a financing statement in order to have a security interest that is effective in bankruptcy. These costs would, of course, be passed on to the consumer."\textsuperscript{45}

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\textsuperscript{38} See id. § 547(c)(1)(B).
\textsuperscript{39} See U.C.C. § 9-317(a)(2) (an unperfected security interest is subordinate to the rights of a judicial lien creditor).
\textsuperscript{40} See Employee Abuse Prevention Act of 2002 (Durbin-Delahunt), S. 2798, H.R. 5221, 107th Cong. § 103(b). This subsection would have replaced the phrase "creditor on a simple contract cannot acquire a judicial lien" with the phrase "good faith purchaser for value of such fixture or property that reasonably relied on available information cannot acquire an interest."
\textsuperscript{41} See U.C.C. § 9-308(a) (providing that a security interest is perfected if it has attached and any required public notice has been given, e.g., by filing).
\textsuperscript{42} This example appears in the REPORT, supra note 12, at 8-9.
\textsuperscript{43} See U.C.C. § 9-309(1) (purchase-money security interest in consumer goods is perfected when it attaches).
\textsuperscript{44} See id. § 9-320(b), (c). The statement in the text assumes that, as required in U.C.C. § 9-320(b), the consumer buyer does not know about the security interest and gives value. Id.
\textsuperscript{45} REPORT, supra note 12, at 9.
II. OTHER PRINCIPLES THAT MAY UNDERLIE SECTION 103

Having established that the sponsors' statements concerning the modest effect of Section 103 were inaccurate (even if the sponsors may have believed them to be correct), we now examine a series of alternative assumptions, explanations, and justifications that might underlie the proposal.\textsuperscript{46} We begin by asking whether any principled bankruptcy policy justifies the sponsors' narrow, stated goal of overriding the effects of Revised Article 9 in bankruptcy or their broader goal of protecting employees of, and retirees from, bankrupt firms. We then examine several other principles that might be thought to justify Section 103 and consider whether those principles are consistent with prevailing bankruptcy policies.

A. Should the Avoidance Powers Be Expanded to Restore the Pre-2001 Regime?

The section-by-section analysis of the Bill suggests that Section 103 was necessary because Revised Article 9 deprived judicial lien creditors of certain rights to "set aside suspect transactions."\textsuperscript{47} Two specific characteristics that Section 103 would have afforded to a trustee as a hypothetical good-faith purchaser—the purchaser's hypothetical reliance on hypothetical incorrect information in the public record and its hypothetical possession of the collateral transferred—lead us to consider first whether Section 103 can be justified by either of two specific provisions of Revised Article 9 that distinguish between lien creditors and purchasers: UCC section 9-338, which relates to incorrect information in the public record, and UCC section 9-312(a), under which a security interest in promissory notes and other instruments may be perfected by filing.

1. Should the Trustee Have the Powers of a Reliance Purchaser under UCC Section 9-338?

UCC section 9-338 provides, perhaps, the most plausible and

\textsuperscript{46} We do not speculate on the actual subjective assumptions that any of the sponsors or their staff may have entertained. Instead, we are working from the substance of the proposal and the explanation proffered by the sponsors and offering an objective, merits-focused critique that examines the assumptions and analyses that might plausibly and coherently underlie the proposal.

\textsuperscript{47} See Summary, supra note 2.
modest basis for enacting a new avoidance power in response to changes made by Revised Article 9. That section, which has no antecedent in Former Article 9, enables certain purchasers, but not lien creditors, to cut off or achieve priority over an earlier perfected security interest.\textsuperscript{48} Section 9-338 protects a purchaser only if the competing security interest is perfected by a filed financing statement that contains certain incorrect information and only if the purchaser reasonably relied on the incorrect information in giving value.\textsuperscript{49} The relevant incorrect information for these purposes is the information specified in UCC section 9-516(b)(5): a mailing address for the debtor, an indication of whether the debtor is an individual or an organization, and, if the financing statement indicates that the debtor is an organization, a type of organization for the debtor, a jurisdiction of organization for the debtor, and the debtor’s organizational identification number or an indication that the debtor has none.\textsuperscript{50}

To assess whether a trustee in bankruptcy should have the rights of a purchaser under UCC 9-338, it is necessary to understand the role section 9-338 plays in the Article 9 scheme. If any of the section 9-516(b)(5) information is missing, the filing office may reject the filing; indeed, it is required to do so.\textsuperscript{51} If, however, the filing office accepts the filing notwithstanding the missing information, the filing nevertheless may be effective to perfect a security interest.\textsuperscript{52}

Comment 3 to UCC section 9-520 explains some of the thinking behind this statutory structure:

The information required by Section 9-516(b)(5) assists searchers in weeding out “false positives,” i.e., records that a search reveals but which do not pertain to the debtor in question. It assists filers by helping to ensure that the debtor’s name is correct and that the financing statement is filed in the proper jurisdiction.

If the filing office accepts a financing statement that does not give this information at all, the filing is fully effective. Section 9-520(c).

\textsuperscript{48} If a qualifying purchaser is a not a secured party (e.g., is a buyer), it “takes free” of the perfected security interest. See U.C.C. § 9-338(2). If the purchaser is a secured party, the perfected security interest is subordinate to the purchaser’s security interest. See id. § 9-338(1).

\textsuperscript{49} See id. § 9-338.

\textsuperscript{50} See id. § 9-516(b)(5).

\textsuperscript{51} See id. §§ 9-516(b); 9-520(a).

\textsuperscript{52} See id. §§ 9-502(a) (specifying information required in an effective financing statement to be the name of the debtor, the name of the secured party or its representative, and an indication of the collateral covered by the financing statement); 9-520(c) (providing that a filed financing statement containing information specified in § 9-502(a) and (b) is effective even if the filing office is required to refuse to accept it for filing). A secured party who intentionally includes incorrect information in a financing statement in order to mislead third parties could be found to have acted in bad faith, with the result that its security interest might be subordinated even to a purchaser who did not qualify for protection under section 9-338. See id. §§ 1-203 (contract or duty under UCC imposes obligation of good faith); 9-102(43) (defining “good faith” as “honesty in fact and the observance of reasonable commercial standards of fair dealing”).
The financing statement also generally is effective if the information is given but is incorrect; however, Section 9-338 affords protection to buyers and holders of perfected security interests who give value in reasonable reliance upon the incorrect information.\(^5^3\) This approach induces a secured party to include potentially useful information in the public record, thereby providing a higher quality of public notice. But it does so without exposing the filing secured party to the risk that its security interest will be unperfected, and thus vulnerable to judicial lien creditors and the debtor’s bankruptcy trustee, if some information is missing or inaccurate.\(^5^4\) UCC section 9-338 was designed to strike a rough balance—to impose consequences that are large enough to induce secured parties to provide correct information, but are not so large as to induce the expenditure of substantially greater resources than the benefits of correct information likely would warrant. Towards this end, section 9-338 rewards a competing secured party or other purchaser with a senior claim to collateral only if that purchaser proves that it was aware of the contents of a financing statement and actually and reasonably relied on the incorrect information.

Section 9-338 protects a very narrow class of purchasers outside bankruptcy. Even if one thinks the class should be expanded to include the debtor’s trustee in bankruptcy, Section 103 is drafted much too broadly. As the Report noted:

The Act’s expanded avoidance powers could be curbed by revising it to address only (i) the rights of a good faith purchaser that relies on incorrect information under UCC § 9-338 and (ii) cases in which the public registry actually contains incorrect information in connection with the particular transfer to be avoided. Under this approach, for example, if a financing statement on file actually contained incorrect information that did not render a security interest unperfected under UCC Article 9, the trustee would have the rights of a hypothetical purchaser that hypothetically relied on the actually incorrect information.\(^5^5\)

On examination, however, even this scaled-back version of Section 103 would be inconsistent with the stated rationale for Section 103. An error in the section 9-516(b)(5) information is hardly indicative of a suspect transaction, let alone an abuse that robs employees and retirees of their earnings and retirement savings. Also, this scaled-back version of Section 103 would do much more than simply restore the trustee’s avoidance powers to their pre-Revised Article 9 status. It would expand

\(^{53}\) Id. § 9-520 cmt. 3.

\(^{54}\) There are a number of reasons why inaccurate information may appear in a financing statement. For example, clerical errors may lead to transpositions of numbers in addresses and organizational identification numbers. As the consequences of inaccuracies increase, presumably the costs of ensuring accuracy will rise.

\(^{55}\) REPORT, supra note 12, at 15 (emphasis added).
the trustee's avoidance powers substantially beyond those the trustee enjoys under Bankruptcy Code §§ 544(a)(1) and 547(b) as they applied to secured transactions under Former Article 9. With the exception of the debtor's mailing address, Former Article 9 did not require a financing statement to include the information now relevant to section 9-338.56 Any avoidance power based on inaccuracies in the other relevant information necessarily would expand, and not merely restore, the avoidance power. As a practical matter, Section 103 would have expanded the avoidance powers even had it been limited to hypothetical reliance on errors with respect to the debtor's mailing address. Less than a handful of reported decisions under Former Article 9 held a financing statement to be insufficient because it provided an incorrect or incomplete address for the debtor.57

Moreover, incorrect information gives rise to a subordination or cut-off under section 9-338 only "to the extent that" the purchaser gave value "in reasonable reliance" on it.58 Because a trustee in bankruptcy cannot actually give value, actually rely on incorrect information, or actually be reasonable in its reliance, the only way to give the trustee the powers of a section 9-338 purchaser is to provide the trustee with hypothetical reasonable reliance in hypothetically giving value. Thus, even under a narrowed version of Section 103, the trustee could avoid a security interest completely based on its hypothetical reliance in every case in which any portion of the relevant information proved to be incorrect.

Section 103 arguably could have been narrowed even more, to place on the trustee the burden of showing at least that it would have been reasonable for a purchaser to rely on the incorrect information in the filed financing statement. But with no actual purchaser, no actual reliance, no actual value given, and no actual context or circumstances surrounding the hypothetical purchase, that burden no doubt would be

56 See Former U.C.C. § 9-402(1) (specifying information required in an effective financing to include "a mailing address of the debtor").
57 Our examination of the Uniform Commercial Code Reporting Service case digest for Former UCC section 9-402 revealed only four reported decisions (indexed under "Address requirements") in which an incomplete or inaccurate address was the basis for a determination that a financing statement was ineffective. See Uniform Commercial Code Reporting Service, U.C.C. Search, Case Digest, supra note 7. In one of these decisions, In re Michelle's Hallmark Cards & Gifts, Inc., 219 B.R. 316 (Bankr. M.D. Fla. 1998), the debtor's name was wrong, as well. The other three decisions were decided decades ago, and two of them were decided by the same judge. See In re Wood, 33 B.R. 375 (Bankr. D. Idaho 1983); In re Brawn, 7 U.C.C. Rep. Serv. 565 (Bankr. D. Me. 1970); In re Brawn, 6 U.C.C. Rep. Serv. 1031 (Bankr. D. Me. 1969). Some courts, albeit a minority of those that have considered the issue, have held financing statements to be adequate under Former section 9-402 even in the complete absence of a debtor's address where no prejudice existed. Lines v. Bank of California, 467 F.2d 1274 (9th Cir. 1972); Riley v. Miller, 549 S.W.2d 314 (Ky. 1977); In re Fowler, 407 F. Supp. 799 (W.D. Okla. 1975); In re French, 317 F. Supp. 1226 (E.D. Tenn. 1970).
58 U.C.C. § 9-338(1), (2).
easy to meet. Section 9-338 itself contemplates that a purchaser could reasonably rely on any of the relevant incorrect information. In effect a trustee might meet this sort of burden merely by showing that it is conceivable that a purchaser could actually and reasonably rely on the incorrect information.

Because a trustee’s 9-338-based avoidance powers must necessarily arise out of a hypothetical purchaser’s hypothetical reliance under hypothetical circumstances, it is impossible for those powers to mimic, or even reasonably approximate, the actual risks that section 9-338 imposes outside bankruptcy. In striking the balance reflected in section 9-338, the drafters of Revised Article 9 expected that actual and reasonable reliance on incorrect information would occur only on “rare occasions.” Under the Bill’s hypothetical reliance standard, however, a trustee may “convert a rare event in the real world into an automatic event in bankruptcy.”

Perhaps a very different statutory approach might meet both the objection to the hypothetical nature of a trustee’s rights and the argument that a section 9-338-based avoidance power in bankruptcy would materially increase the section 9-338 risk that a secured party faces outside bankruptcy. Consider an avoidance power that would allow the trustee to assert the rights of an actual purchaser who, on the date of the bankruptcy filing, had an actual right to take free of, or to subordinate, a security interest under section 9-338. This power would be somewhat analogous to the trustee’s power to assert the rights of actual unsecured creditors to avoid certain transfers (mainly fraudulent transfers) under Bankruptcy Code § 544(b)(1). However, the analogy fails because, at the time a debtor enters bankruptcy, a creditor whose

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59 See U.C.C. § 9-338 cmt. 2 ("On rare occasions, a subsequent purchaser of the collateral (i.e., a buyer or secured party) may rely on the misinformation to its detriment."). Outside bankruptcy the burden on an actual purchaser to prove reasonable reliance would be quite difficult to meet. Consider the example mentioned in the Report.

[A]ssume a prospective purchaser searches the public record and finds a financing statement filed against the debtor’s correct name. The searcher, however, notices that the address given for the debtor is not correct. In order to benefit from UCC § 9-338, the searcher would be required to convince a court that it acted reasonably in purchasing the collateral in reliance on its belief that the financing statement filed against the debtor’s correct name was not filed against the debtor, but actually was filed against someone else altogether.

REPORT, supra note 12, at 16 n.28.

60 Id. at 17.

61 See 11 U.S.C. § 544(b)(1). Under the accepted interpretation of this section, a trustee may avoid a transfer for the benefit of all unsecured creditors, not just for the benefit of creditors who actually have the power of avoidance, and the trustee may avoid a transfer in its entirety, not merely to the extent of the claims held by creditors who actually have the power of avoidance. See Moore v. Bay, 284 U.S. 4 (1931) (applying § 70e of the Bankruptcy Act, 11 U.S.C. § 110e (1976) (repealed effective Oct. 1, 1979), the predecessor to Bankruptcy Code § 544(b)(1)). The Court’s decision in Moore has been criticized frequently. For a summary of the criticisms, see CHARLES JORDAN TABB, THE LAW OF BANKRUPTCY § 6.6, at 346-48 (1997).
avoidance power the trustee asserts under § 544(b) has only the potential ability to avoid transfers; it has not actually done so (by acquiring a nonavoidable judicial lien, for example).62 In contrast, a purchaser with senior rights under section 9-338 has actually achieved senior status through its actual and reasonable prebankruptcy reliance. What would be the effect of giving the trustee the rights and powers of an actual purchaser who holds a senior interest? It would be bizarre (as well as patently unfair) to enable the trustee to displace the actual reliance purchaser for the benefit of the creditors generally, that is, to avoid not only the avoidable security interest but the reliance purchaser’s otherwise nonavoidable interest as well. Alternatively, perhaps the reliance purchaser’s interest could stand while the trustee avoids, for the benefit of all creditors, any remaining interest held by the junior competing secured party. That result would be inconsistent, however, with the effort to moderate Section 103 to merely mimic nonbankruptcy risks in bankruptcy.63 And it would clearly contravene the accepted policy implemented by the Bankruptcy Code of limiting the rights of a trustee under § 544(b)(1) to those of actual unsecured creditors.64

In sum, even a narrowed Section 103 approach would conflict with the sponsors’ stated goal of restoring the avoidance powers as they were exercised before UCC Article 9 was revised. Any attempt to confer a section 9-338-based avoidance power on bankruptcy trustees either would expand the risks posed to holders of perfected security interests well beyond those that obtain outside bankruptcy or would unjustifiably expropriate the priorities and interests of the very reliance purchasers that section 9-338 is intended to protect.65

In his response to this Article, Professor Ted Janger takes

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62 See, e.g., Uniform Fraudulent Transfer Act §§ 7(a) (2003) (stating general remedies of creditor as to avoidable transfers); 7(b) (providing that, if court so orders, a judgment creditor may levy execution on asset transferred by debtor in an avoidable transfer), 7A U.L.A. 339-40 (1999).

63 It also would follow the unfortunate precedent of Moore v. Bay. See supra note 61.

64 See Collier on Bankruptcy ¶ 544.09[1], at 544-18 (15th ed. 2003).

65 The Report noted two additional undesirable consequences of a narrowed UCC section 9-338-based Section 103. First, because the inclusion of section 9-338-related incorrect information does not destroy perfection, one might expect more inaccuracies in that information than in the perfection-related information. Thus, the Report observed, enactment of Section 103 would render avoidable many security interests perfected before Section 103 became effective. REPORT, supra note 12, at 16-17. In addition, the Report predicted that enactment of Section 103 would prompt many state legislatures to repeal section 9-338 or eliminate the section 9-516(b)(5) information from financing statements. Id. at 17.

In short, both the underlying concept and the drafting of Section 103 were fundamentally flawed. Given this conclusion, it is understandable that two of the Report’s co-authors, widely respected for their drafting skills and substantive expertise in the law of secured transactions and bankruptcy, declined the invitation of a prominent bankruptcy academic to redraft Section 103 so that it would “work.”
exception to section 9-338. We take Professor Janger’s principal factual claim to be that unsecured creditors sometimes make credit decisions in reliance on incorrect information contained in financing statements. From this he argues that section 9-338 unfairly discriminates against unsecured creditors because it benefits only purchasers, including secured parties.

Perhaps a more coherent and straightforward statement of Janger’s complaint would be that he believes that the information relevant to section 9-338 should be required as a condition of perfection along with the information currently specified in section 9-502. Under such a revision, if any of that information were seriously misleading then the financing statement would not be effective and the security interest would be avoidable under the current version of the strong-arm power. Janger acknowledges that this type of incorrect information would be seriously misleading to an unsecured creditor only in “rare cases.”

Another plausible method of meeting Janger’s concerns would be to add lien creditors who actually rely on incorrect information to the class of persons benefited by section 9-338. Indeed, that would address precisely the unfair discrimination that Janger claims to be imposed by section 9-338. But given how rare such actual reliance would be in practice, Janger’s concern seems trivial.


67 This is implicit in Janger’s argument for a “simple solution” that would subject all information to the “seriously misleading” standard of UCC section 9-507 and Former section 9-402(a). Id.

68 See supra text accompanying notes 22-23.

69 Janger, supra note 66, at 110. The cases may be even more rare than Janger surmises. He proffers an example in which a prospective unsecured creditor searches the New York filing office and discovers a properly filed financing statement naming a New York corporation as debtor but indicating that the debtor is incorporated in Delaware. We doubt the prospective creditor would be acting reasonably if it concluded that the financing statement was filed against a Delaware corporation having a different name and extended credit in reliance on that conclusion (i.e., we doubt that the incorrect information is seriously misleading). Financing statements naming Delaware corporations are supposed to be filed in the Delaware filing office. See U.C.C. §§ 9-301(1); 9-307(e); 9-102(a)(50). The debtor named in the New York filing is a New York corporation. At most, the information in the financing statement would prompt a reasonable searcher to inquire further. This might well be the case, even where, as in Janger’s footnote 22, the financing statement sufficiently names both a New York and Delaware corporation.

70 We wonder whether a prospective unsecured creditor ever truly extends credit in reasonable reliance on the perception that nothing has been filed against the debtor. A security interest perfected after the credit was extended nonetheless would have priority over a subsequent judicial lien that the unsecured creditor might obtain. See U.C.C. § 9-317(a)(2)(A). At most, a lien creditor might actually rely on incorrect information in deciding to incur the time, trouble, and expense of obtaining a judicial lien.

As to the materiality of Janger’s concerns, consider as well the small number of reported decisions in which financing statements were determined to be ineffective because of an incomplete or inaccurate debtor’s address under Former Article 9. See supra note 57. Indeed, the
Another response to Janger's concern would be to eliminate all information from financing statements except the information specified in section 9-502.\textsuperscript{71} This would have the benefit of excluding some incorrect information from the public record, but no doubt at the expense of keeping a much greater amount of accurate information out of the public record. Yet that clearly would have been the result of the Article 9 drafting and enactment process had the drafters not devised the structure implicating reasonable reliance under section 9-338 as a substitute for requiring additional information as a condition of perfection. As the Report noted, "[t]he drafters of Revised UCC Article 9, and the state legislatures that have enacted it, would never have required this additional [non-section 9-502] information to be included in a financing statement if the result of an inaccuracy would be the certain avoidance by the debtor's trustee in bankruptcy."\textsuperscript{72}

The information that should be required for perfection by filing and the appropriate scope of the priority rule in section 9-338 are matters about which reasonable persons might quibble, but they are not matters we address in this Article. Janger's concerns have little, if anything, to do with the proposition that we are advancing here, that is, that expanding the trustee's avoidance powers to include the rights of hypothetical good-faith purchasers of personal property and fixtures would represent an enormous, and unjustified, extension of those powers.

2. Should the Trustee Have the Powers of a Reliance Purchaser under UCC Section 9-330(d)?

Section 103 would have given the trustee the rights of a good-faith purchaser for value who took possession of the transferred property (i.e., the collateral), even if the property was not of a type that in fact could be possessed. This emphasis on possession leads us to inquire whether the section may be justified as a response to the Revised Article 9's perfection and priority rules governing security interests in promissory notes and other instruments.

Under section 9-330(d), a purchaser of an instrument has priority over a security interest in the instrument perfected by a method other

\begin{footnotes}
\item[71] That would reinstate the formal requisites of a financing statement under Former section 9-402(1), with the exception of the debtor's address and the debtor's signature.
\item[72] REPORT, supra note 12, at 17. We also doubt that the drafters of the revisions would have favored retaining the debtor's address as a component of the information necessary for perfection.
\end{footnotes}
than possession, if the purchaser gives value and takes possession of the instrument in good faith and without knowledge that the purchase violates the rights of the secured party.\textsuperscript{73} Comparing this rule to the corresponding rule in Former section 9-308, which also subordinated perfected security interests in instruments to purchasers who took possession of the instrument, one might wonder what the fuss is about.\textsuperscript{74}

The answer lies elsewhere in the revisions, specifically in the method of perfection that is available for security interests in instruments. Under Former Article 9, long-term perfection in an instrument could not be achieved by filing; the secured party needed to take possession.\textsuperscript{75} Revised Article 9 adds filing as an acceptable method of perfection.\textsuperscript{76} This change means that a judicial lien creditor no longer can avoid a security interest in an instrument where the secured party has filed a financing statement but has not taken possession.

As is the case with section 9-338, the perfection-by-filing rule in section 9-312(a) implicates good-faith transactions and not corporate abuses.\textsuperscript{77} And, as is the case with section 9-338, the Bill is so broad that it would have affected a world of perfected security interests that were invulnerable to judicial liens under Former Article 9.\textsuperscript{78} Article 9 has always contained non-temporal priority rules that, like section 9-330, favor certain later-in-time claimants, including secured parties.\textsuperscript{79} While the 1994 revisions to UCC Article 8 and the recent revisions to Article 9 added additional non-temporal priority rules to accommodate developing financing patterns,\textsuperscript{80} filing remains Article 9’s principal

\textsuperscript{73} See U.C.C. §§ 9-330(d); 9-102(a)(47) (defining “instrument”).

\textsuperscript{74} The class of purchasers whom Revised Article 9 protects differs in some ways from the class protected by Former section 9-308. Compare U.C.C. § 9-330(d), with Former U.C.C. § 9-308(a), (b). Under section 9-330(d) a purchaser of an instrument need not take possession in the ordinary course of business as Former section 9-308(a) and (b) required.

\textsuperscript{75} See Former U.C.C. § 9-304(1).

\textsuperscript{76} See U.C.C. § 9-312(a) (stating that “[a] security interest in . . . instruments . . . may be perfected by filing.”)

\textsuperscript{77} As we explained elsewhere, perfection by filing for security interests in instruments may materially reduce transactions costs. See Steven L. Harris & Charles W. Mooney, Jr., Revised Article 9 Meets the Bankruptcy Code: Policy and Impact, 9 Am. Bankr. Inst. L. Rev. 85, 96 (2001) [hereinafter Harris & Mooney, Policy and Impact]. “A perfection-by-filing rule ‘avoids the costs and impracticalities of taking possession when the collateral consists of large numbers of instruments.’” Id. n.57 (quoting Steven L. Harris & Charles W. Mooney, Jr., How Successful Was the Revision of UCC Article 9: Reflections of the Reporters, 74 Chi.-Kent L. Rev. 1357, 1361 n.16 (1999)). It also “makes it unnecessary to determine whether a particular writing is an instrument or to make alternative assumptions, necessitating both filing and taking possession.” Id.

\textsuperscript{78} See supra discussion Part I.A.

\textsuperscript{79} For example, the predecessor to UCC section 9-330 was Former section 9-308, which was quite similar to the newer version. Compare U.C.C. § 9-330, with Former U.C.C. § 9-308. Former UCC section 9-309, which preserves the rights of certain good-faith purchasers under UCC Articles 3, 7, and 8, is carried forward in UCC section 9-331. Compare U.C.C. § 9-331, with Former U.C.C. § 9-309.

\textsuperscript{80} See, e.g., U.C.C. §§ 9-327 (stating priority rules for security interests in deposit accounts);
method of giving public notice. Although it would be feasible to craft a narrow avoidance power that would restore the pre-revision result, we see no bankruptcy policy that would require, or even be able to justify, doing so. Indeed, we expect that permitting perfection by filing against instruments will increase the likelihood that unsecured creditors learn that a debtor’s instruments have been encumbered. To the extent that the objections to sections 9-338 and 9-312(a) arise from a belief that secret liens are antithetical to bankruptcy policy, it seems odd that the belief would lead one to object to perfected-by-filing security interests in instruments.

B. Would Scaling Back Security Interests in Bankruptcy Generally Benefit Employees and Retirees?

The sponsors of the Bill touted its virtues as a benefit for employees and retirees (presumably former employees). The following passage, taken from the August 1, 2001 press release issued by Congressman Delahunt and Senator Durbin, exemplifies their claims:

Prompted by the recent wave of corporate bankruptcies, Senator Dick Durbin (D-IL) and Congressman Bill Delahunt, D-MA) today unveiled tough legislation to curb abuses that deprive employees and retirees of their earnings and retirement savings when businesses collapse.

"From Enron to Polaroid, the recent wave of bankruptcies has left tens of thousands of employees without jobs, retirees without pensions or health insurance—while corporate assets are diverted to executive bonuses and off-book transactions," Delahunt said.

"Some have asked, 'Why introduce this bankruptcy bill at this time?' To put it simply, there is no better time," Durbin said. "The confidence of American workers and retirees has been severely

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81 See U.C.C. § 9-310(a) (providing general rule that filing is necessary to perfect all security interests). At least one commentator has claimed that Revised Article 9 has created a "bifurcated" system of perfection, with one set of standards applicable to priority over judicial lien creditors (the trustee in bankruptcy) and another applicable to priorities among competing security interests. See G. Ray Warner, The Anti-Bankruptcy Act: Revised Article 9 and Bankruptcy, 9 AM. BANKR. INST. L. REV. 3, 32-35 (2001). For a contrary view, see Harris & Mooney, Policy and Impact, supra note 77, at 95-97.

82 Professor Janger shares this expectation. See Janger, supra note 70, at 107-08 (suggesting that unsecured creditors rely on the Article 9 filing systems). Under Former Article 9, a security interest in instruments other than proceeds could be perfected only by possession or temporarily. See Former U.C.C. § 9-304(1).
shaken by an epidemic of corporate greed and corruption. This bill says that if a company goes bankrupt and engages in unfair practices in the process, the forgotten victims—employees and retirees—won't be asked to pay the price.”

And, as reported by CongressDaily, “[a]sked in an interview today whether the [Bill] was meant to be viewed as an alternative or complement to the pending bankruptcy reform legislation, Durbin responded: ‘That was a bankruptcy bill for corporations. This is a bankruptcy bill for workers.’”

We have already demonstrated that Section 103 cannot be understood to address “abuses,” “corporate greed,” or “unfair practices.” In this section we consider whether enactment of Section 103 (or a narrower version, such as that outlined in the previous section) would be likely to accomplish the sponsors’ larger expressed goal, that of promoting the interests of employees and retirees. We conclude that enactment of Section 103 in any form would be unlikely to accomplish this result.

One knowledgeable source indicated that the Bill’s sponsors focused first on provisions that would enhance the preferential treatment that the Bankruptcy Code already gives to claims of employees and retirees. These provisions ultimately appeared in Title II of the bill. Sometime later the sponsors and their staffs realized what may have been obvious—more preferential treatment for employees and retirees would be hollow unless sufficient assets were available for satisfaction of their claims. The provisions in Title I, including Section 103, were included so that “plundered assets” would be recoverable for this purpose.

No one can deny that employees or retirees who hold claims against a firm in bankruptcy will benefit by having more assets

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83 Press Release, supra note 2.
84 CONGRESSIONAL DAILY (August 1, 2002), at http://nationaljournal.com/about/congressdaily.
85 See supra discussion Part I.
86 See, e.g., 11 U.S.C. §§ 507(a)(3) (2004) (affording priority to certain claims for wages, salary, or commissions); 507(a)(4) (affording priority to certain claims for contributions to an employee benefit plan); 1114 (requiring payment, and restricting modification, of retiree benefits).
87 “Title II of the bill provides a number of remedies to help ensure that once the plundered assets have been recaptured for the estate, employees and retirees have the opportunity to assert their claims to a fair share of the proceeds.” Press Release, supra note 2.
88 Interview conducted by Charles W. Mooney, Jr. with congressional staff member (December 12, 2002).
89 Press Release, supra note 2. Of course, it is preposterous to suggest that the transfers of collateral that would have been recovered under Section 103 constitute “plundered assets” as opposed to legitimate commercial transactions. In a secured transaction “assets of an equal or greater value (e.g., loaned funds or purchased property) come in as the debtor’s property consisting of new assets, a feature the sponsors have not mentioned.” REPORT, supra note 12, at 14 n.22.
available for the payment of unsecured claims and, where applicable, priority claims.\footnote{The statement in the text assumes that the firm’s bankruptcy estate would not otherwise pay the relevant claims in full. The Bill would have expanded the asset base not only by expanding the avoidance powers, see Employee Abuse Prevention Act of 2002 (Durbin-Delahunt), S. 2798, H.R. 5221, 107th Cong. § 103, but also by subordinating certain secured claims to certain claims of retirees. See id. § 203; see also 11 U.S.C. § 726(a) (order of distribution to holders of claims).} But once one assumes, as we do, that the firms against which most employees and retirees hold claims are not in bankruptcy, this observation sheds little, if any, light on whether employees and retirees generally would have benefited from Section 103’s greatly expanded power to avoid perfected security interests. The observation fails to take into account that the treatment of secured claims in bankruptcy affects the cost and availability of secured credit. One ought not simply have assumed that, after enactment of Section 103, all would remain constant and the financial picture of debtors would be identical in bankruptcy except for the fact that collateral would be recovered for the benefit of employees and retirees. This is not how the world works.\footnote{Many traditional bankruptcy practitioners and academics continue to cling to this assumption nevertheless. See Douglas G. Baird, Bankruptcy’s Uncontested Axioms, 108 YALE L.J. 573, 589-92 (1998) (proceduralists, unlike traditionalists, emphasize the instrumental aspects of bankruptcy law); see also Harris & Mooney, Policy and Impact, supra note 77, at 97-111 (discussing the impact of Revised UCC Article 9 on unsecured creditors).} Were Section 103 to become applicable to a proposed secured credit transaction, prospective creditors would take into account its effects. If a proposed security interest would have been avoidable under Section 103, then the credit either would not have been extended at all or would have been extended in a smaller amount or at a higher cost. If the credit were not extended, then the debtor would not have acquired the loan proceeds or property in the credit transaction and those funds or property would not have become part of the debtor’s estate in bankruptcy.

The Report emphasized this instrumental effect of Section 103 on the extension of credit, as did the President’s Working Group in its trenchant explanation that the Bill would harm the very employees and retirees that its sponsors claimed would be its beneficiaries.\footnote{See REPORT, supra note 12, at 9-10; Letter to Paul H. O’Neill et al., supra note 17.} The most direct victims would have been employees and former employees whose employers would not have obtained necessary credit or would have done so only in lower amounts or at higher costs. Credit contractions also would have affected those individuals whom potential employers would have lacked the financial resources to hire in the first place. Employees and retirees of firms that never would have entered bankruptcy probably would have borne the brunt of Section 103’s effects. On the other hand, the instrumental effects of Section 103 also would have fallen on employees and retirees of bankrupt firms that had
been unable to obtain necessary extensions of credit.\footnote{These points raise empirical questions that we have explored elsewhere. See Steven L. Harris & Charles W. Mooney, Jr., Measuring the Social Costs and Benefits and Identifying the Victims of Subordinating Security Interests in Bankruptcy, 82 CORNELL L. REV. 1349 (1997).} The point is that one cannot make any responsible assessment of whether Section 103 generally would have harmed or benefited employees and retirees of firms, inside or outside of bankruptcy, without taking into account the instrumental effects of the provision, including its effects on the credit and financial markets.

Like the sponsors’ claim that Section 103 would have restored avoidance powers lost by the revision of UCC Article 9, the claim that Section 103 generally would have benefited employees and retirees is not supportable.

C. Is the Expansion of Avoidance Powers in Section 103 Consistent with Bankruptcy Policy?

Sections II.A and B above examined the sponsors’ stated justifications for Section 103 and found them unpersuasive. In this section we extract from the text of Section 103 several other, unstated principles that might be thought to underlie the proposed expansion of avoidance powers. We conclude that none of these principles reflects sound bankruptcy policy.

1. Should a Security Interest that Is Vulnerable to Any Other Claim under Any Circumstances Be Avoidable in Bankruptcy?

One possible basis for expanding the avoidance powers would be to put a trustee, as a representative of creditors, in a position as strong as that of every other person vis-a-vis a security interest. Otherwise posited, the argument would be that if anyone under any circumstances could take priority over or cut off a security interest, the trustee should have the rights and powers of that hypothetical person. For convenience, we refer to this avoidance power as the “most-favored-claimant” power. We find no sound bankruptcy policy basis for expanding the trustee’s avoidance powers along these lines.

One way to test the merits of the most-favored-claimant avoidance power is to ask whether it would promote the policies underlying the principal avoidance powers (i.e., the “strong-arm” power, the preference avoidance power, the power to avoid fraudulent transfers, and the power to avoid statutory liens).\footnote{See 11 U.S.C. §§ 544(a)(1) (“strong-arm” power); 544(b); 545 (statutory-lien avoidance);} Consider first the “strong-arm” power, which
confers upon a trustee the rights and powers of a hypothetical judicial lien creditor as of the time the bankruptcy case is commenced. The strong-arm power is best understood by viewing the trustee as a de facto judicial lien creditor for the benefit of all creditors. Just as creditors could have obtained judicial liens outside bankruptcy against property subject to an unperfected security interest, so a trustee obtains a judicial lien on their behalf in bankruptcy and may avoid the unperfected security interest. Because the strong-arm power avoids unperfected security interests for the benefit of creditors generally, it complements bankruptcy’s equal (pro rata) sharing principle.

While the strong-arm power serves bankruptcy’s policy of equality and mimics creditors’ nonbankruptcy entitlements, the most-favored-claimant power would extend the trustee’s avoidance powers much farther. As explained above, for example, under Section 103 (a version of the most-favored-claimant approach) the trustee would have been able to assert the rights of a hypothetical buyer in ordinary course of the debtor’s inventory to cut off a security interest in the inventory even if the security interest was perfected. The effect of avoidance under the

547(b) (preference avoidance); 548 (fraudulent-transfer avoidance). The Bankruptcy Code contains other avoidance powers, but these are not relevant to the discussion. See, e.g., id. § 549 (postpetition-transfer avoidance).

95 See id. § 544(a)(1). Section 544(a) also arms a trustee with the rights and powers of a hypothetical creditor who obtains an execution that is returned unsatisfied, see 11 U.S.C. § 544(a)(2), and a hypothetical bona fide purchaser of real property, other than fixtures. See 11 U.S.C. § 544(a)(3). We discuss the latter provision infra Part II.C.2. David Carlson has argued that the trustee’s strong-arm power is the organizing principle of bankruptcy. David Gray Carlson, Bankruptcy’s Organizing Principle, 26 Fla. St. U. L. Rev. 549, 555-59 (1999) [hereinafter Carlson, Principle].

96 As we have explained elsewhere, traditionally, upon the commencement of an involuntary bankruptcy case, a trustee took possession of the debtor’s assets; the creditors represented by the trustee thereby acquired a lien on the debtor’s property. Although most bankruptcy petitions now voluntary, the result should be the same regardless of how a bankruptcy case is commenced. When a judicial officer takes control over the debtor’s property for the benefit of creditors, the creditors (or their representative) thereby should acquire a lien. Like any other lien that arises through the judicial process or through the exercise of a collective creditors’ remedy, the lien that arises on bankruptcy should take priority over an unperfected security interest. See JOHN O. HONNOLD ET AL., SECURITY INTERESTS IN PERSONAL PROPERTY 441 (3d ed. 2000).

97 See U.C.C. § 9-317(a)(2)(A) (providing that an unperfected security interest in personal property or fixtures is subordinate to a person who becomes a lien creditor before the security interest is perfected); 9-102(a)(52) (defining “lien creditor”).

98 Once a security interest is avoided, the value of the collateral is available for distribution to priority creditors and then to unsecured creditors on a pro rata basis. See 11 U.S.C. §§ 507(a) (priority claims); 726(a) (order of distribution to holders of claims). An unsecured creditor and the holder of an unperfected security interest are “equal,” in the sense that either could have succeeded in appropriating the value of the collateral to the exclusion of the other—the secured party by perfecting its security interest and the unsecured creditor by acquiring a judicial lien. The strong-arm power in effect declares a “tie” among the unsecured creditors and the unperfected security interest; it preserves the unperfected security interest for the benefit of all. See TABB, supra note 61, § 6.5, at 338-39; THOMAS JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW 70-75 (1986).

99 See supra discussion Part I.A.
most-favored-claimant approach, then, would be to confer benefits on the debtor’s unsecured creditors that would not have been available under nonbankruptcy law.\textsuperscript{100}

Consider next the trustee’s power to avoid preferences under Bankruptcy Code § 547. Preference law enables the trustee to avoid certain prebankruptcy transfers that result in giving a particular creditor more than its pro rata share of the debtor’s assets.\textsuperscript{101} Unlike the strong-arm power, preference avoidance does not generally mimic a nonbankruptcy priority rule.\textsuperscript{102} Instead, it “undoes payment and security of debt” that may be completely legitimate under nonbankruptcy law\textsuperscript{103} and may be completely invulnerable to an attack by unsecured creditors.

Preference law can be appreciated best by focusing on the effect of a prebankruptcy transfer to one creditor on the debtor’s other, nonpreferred creditors. Assets transferred to a creditor shortly before bankruptcy, whether as payment or as collateral, deplete the debtor’s estate. If the transfers were to stand, those assets would be unavailable in a Chapter 7 liquidation to satisfy the other creditors’ claims. The creditor who receives the prepetition transfer is said to have been \textit{preferred} to the detriment of the other creditors. When a transfer is avoided as a preference under § 547(b), however, the assets (or their value) are restored to the debtor’s estate to be shared by all creditors.\textsuperscript{104}

Traditional preference jurisprudence suggests that preference law is designed to promote equality of distribution among unsecured creditors.\textsuperscript{105} By recovering a preference from the preferred creditor,

\textsuperscript{100} As the \textit{Report} observed, “[t]he Act … confers on unsecured creditors benefits that they could not have enjoyed outside bankruptcy.” \textit{REPORT}, supra note 12, at 11.

\textsuperscript{101} Section 547(b) provides for the avoidance of transfers, including security interests, of a debtor’s property that are made “to or for the benefit of a creditor … on account of an antecedent debt.” 11 U.S.C. § 547(b). A transfer generally is not voidable unless it is made while the debtor is insolvent and within ninety days before the date that the debtor’s bankruptcy petition is filed. \textit{Id}. The debtor is presumed to have been insolvent during the ninety-day period. \textit{Id}. The ninety-day period is extended to one year if the creditor is an insider. \textit{Id}. In addition, a transfer is avoidable only if it allows the creditor to obtain more than it would have obtained in a Chapter 7 liquidation case had the transfer not been made and had the creditor received its distribution in the Chapter 7 case. \textit{Id}. This last element normally is easy for the trustee to establish. Unless the creditor would have received 100% of its claim in Chapter 7 (i.e., unless the bankruptcy debtor is solvent), a prepetition payment necessarily improves the creditor’s position. The same can be said for a prepetition transfer of collateral to secure an antecedent unsecured debt.

\textsuperscript{102} Some states also have preference laws, however. \textit{See}, \textit{e.g.}, 39 PA. CONS. STAT ANN. § 151 (2003).


\textsuperscript{104} \textit{See} 11 U.S.C. §§ 550 (providing for recovery of avoided transfers); 551 (providing for automatic preservation of avoided transfer for the benefit of the estate).

preference law prevents the creditor from retaining payments and other transfers of property that otherwise would have been shared more widely. By putting the preferred creditor in the same position as the other creditors, who have not been preferred, preference avoidance blunts the advantage that certain creditors otherwise would have enjoyed.

This justification is consistent with the current treatment of security interests under § 547. A security interest that is transferred on account of an antecedent debt is eligible for preference avoidance just like the transfer of any other interest in the debtor’s property.106 A security interest that is created in exchange for new value ordinarily is not avoidable as a preference.107 However, even a security interest that is created in exchange for new value may be avoided if perfection of the security interest is delayed such that the act of perfection might be a “last-minute grab” by the secured party.108

Some argue that preference law ought to do (and, at least to some extent, actually does) more than protect the bankruptcy rule of pro rata sharing. They assert that preference law should deter creditors from obtaining payment whenever the debtor approaches bankruptcy.109 In their view, preference law should be (and largely is) directed to “opt-out behavior”—acts by which creditors seek to remove themselves from an impending collective proceeding (bankruptcy) by “gun-jumping” and, in doing so, destroy value.110 While this vision may be plausible in some contexts, most agree that deterrence is, at best, an incomplete explanation and justification.111 Indeed, many creditors probably

U.S.C.C.A.N. 5963, 6138 (“the preference provisions facilitate the prime bankruptcy policy of equality of distribution among creditors of the debtor”).

106 See 11 U.S.C. §§ 547(b)(2), (c)(1); 101(54) (defining “transfer”).

107 See id. § 547(b)(2), (c)(1).

108 Under § 547(e), unless a transfer is perfected within ten days after it becomes effective between the parties, the transfer takes place at the time of perfection. See id. § 547(e)(2)(A), (B). For this purpose perfection occurs when a contract creditor could not obtain a judicial lien that is senior to the transferee’s interest. See id. § 547(e)(1)(B). Thus, in the case of an Article 9 security interest, perfection occurs under preference law at the time the security interest is perfected under Article 9, see U.C.C. § 9-317(a)(2), unless it is perfected under Article 9 within ten days after it attaches. See id. § 9-203(a), (b) (a security interest becomes enforceable when it attaches). Although the policy basis for this treatment of delayed perfection is not entirely clear, it is consistent with the equality-based justification for preference law. See HONNOLD ET AL., supra note 96, at 449-50 (identifying potential underlying policies as a policy against secret liens and an “anti-last-minute-grab” policy).

109 See, e.g., H.R. REP. No. 595, 95th Cong., 1st Sess. 177-78 (1977) (voidable preference law may discourage creditors “from racing to the courthouse to dismember the debtor during his slide into bankruptcy”); JACKSON, supra note 98, 123–38.

110 For example, the removal of a key asset may diminish the value of the debtor’s business, and thus the amount available for distribution to creditors, by an amount substantially greater than the stand-alone value of the asset removed. When a preferred creditor receives cash, however, the detrimental effects on the value of the assets available for distribution to creditors are considerably smaller.

111 Deterrence (when it actually occurs) also serves the equality policy by causing the debtor’s
encourage a payment sooner rather than later in the hope that the 90-day period will elapse before a bankruptcy petition is filed.\textsuperscript{112}

One might argue that a most-favored-claimant avoidance power would serve both the equality and the deterrence policies of preference law. It would, as explained above, result in most secured parties becoming unsecured in bankruptcy,\textsuperscript{113} with the consequence that creditors would be deterred from taking security interests. However, this argument distorts the meaning of the equality and deterrence policies as those policies are currently understood. The equality principle does not require treating all creditors equally. The Bankruptcy Code gives effect to statutory, consensual, and judicial liens.\textsuperscript{114} The equality principle refers to the equality of unsecured creditors and those whose property claims can be defeated by unsecured creditors. Moreover, the deterrence policy is directed towards "last-minute grabs" that deplete the debtor's bankruptcy estate. This policy already applies with full force to the transfer of security interests.\textsuperscript{115} Section 103 would have converted preference law into a mechanism for avoiding security interests that were given in exchange for new value.

The third significant avoidance power is the power to avoid prebankruptcy fraudulent transfers. Bankruptcy Code § 548 empowers the trustee to avoid transfers where the debtor has actual intent to defraud its creditors and purposefully attempts to put assets out of the creditors' reach.\textsuperscript{116} It also empowers the trustee to avoid gifts and other transfers that are constructively fraudulent because the debtor transferred the property when it was in poor financial condition and did not receive a "reasonably equivalent value" in exchange for the transfer.\textsuperscript{117} The trustee can avoid a transfer under § 548 only if the transfer was made within one year before the date on which a bankruptcy petition is filed.\textsuperscript{118} Fraudulent transfers based on actual or constructive fraud are avoidable outside bankruptcy as well.\textsuperscript{119}

\textsuperscript{112} For a brief critique of the deterrence rationale for voidable preference law, see Carlson, supra note 103, at 215-16.

\textsuperscript{113} See supra discussion Part I.

\textsuperscript{114} See, e.g., 11 U.S.C. §§ 101(36), 51, 51 (defining "judicial lien," "security interest," and "statutory lien"); 362(d) (providing for relief from the automatic stay); 506(a) (providing for determination of secured claims); 725 (providing for disposition of property in which a person other than the estate has an interest).

\textsuperscript{115} See supra discussion Part I.B.


\textsuperscript{117} See id. § 548(a)(1)(B) (empowering the trustee to avoid a transfer where the debtor (i) was insolvent, had insufficient capital, or had debts beyond the debtor's ability to pay and (ii) received less than reasonably equivalent value for the transfer).

\textsuperscript{118} See id. § 548(a)(1).

Bankruptcy Code § 544(b) empowers the trustee to avoid transfers avoidable under nonbankruptcy law if an actual unsecured creditor had that power when the bankruptcy case commenced. Under § 544(b), the trustee is bound by (and may take advantage of) the applicable statute of limitations under nonbankruptcy law.

The policies underlying the trustee’s power to avoid fraudulent transfers afford no support for the creation of a most-favored-claimant avoidance power. The avoidance power under § 544(b) is somewhat analogous to the “strong-arm” power, in that it mirrors in bankruptcy the rights of creditors to avoid fraudulent transfers under nonbankruptcy law. As is the case with preferences, no expansion of this power, let alone the vast expansion that a most-favored-claimant rule would work, is needed to accomplish this result. § 544(b) applies to secured transactions with full force. Sections 548 and 544(b) also complement pro rata sharing in the same manner as do the strong-arm and preference avoidance powers: They return the value of fraudulently transferred assets (or their value) to the debtor’s estate. But, as we discussed, the equality goal does not require the general avoidance of security interests or other liens.

In summary, a trustee’s avoidance powers under current law derive primarily from the rights that unsecured creditors enjoy outside bankruptcy or complement the principle of equality and pro rata sharing. A most-favored-claimant avoidance power would have provided to unsecured creditors inside bankruptcy the rights that distinct claimants, such buyers of the debtor’s inventory in the ordinary course of business or new-value purchasers of chattel paper who take possession, enjoy outside bankruptcy. These and other distinct claimants enjoy these nonbankruptcy rights for sound commercial reasons. For example, the rule that ordinary-course buyers of inventory take free of perfected security interests promotes the expectations of both the secured party, who has entrusted the goods to the seller-debtor for the precise purpose of ordinary-course sales, and the buyer, who has

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121 See TABB, supra note 61, § 6.5, at 345-46.
122 See Carlson, supra note 103, at 563-73 (conceptualizing fraudulent transfer avoidance as a part of the strong-arm organizing principle’s model of the trustee holding a judicial lien for the benefit of all creditors). We do not intend to suggest in this brief discussion that we think § 544(b), as it has been construed, represents sound policy. See supra note 61.
123 Section 548 likewise applies to secured transactions with full force. One might consider § 548 as mimicking nonbankruptcy powers but eliminating § 544(b)'s requirement that the trustee identify a specific unsecured creditor having the power to avoid the transfer in question. On the avoidance of fraudulent transfers in bankruptcy, see generally TABB, supra note 61, §§ 6.27-35, at 412-34.
124 A good-faith transferee who took a constructively fraudulent transfer for value has a lien on the property transferred to the extent of any value given in exchange for the transfer. See 11 U.S.C. § 548(c); UNIFORM FRAUDULENT TRANSFER ACT § 8(d) (2003), 7A U.L.A. 352 (1999).
125 See supra text preceding and following note 114.
no reason to expect that the secured party would object to his purchase.\textsuperscript{126} The reason for this rule has no application to creditors who acquire judicial liens. Likewise, the rules that protect ordinary-course purchasers of chattel paper for new value facilitate the acquisition of goods and promote the expectations of the parties.\textsuperscript{127} The reason for this rule, too, has no application to creditors who acquire judicial liens.

The fact that the good-faith purchaser priorities in Article 9 have a sound commercial basis also suggests that the most-favored-claimant principle cannot be justified by Bankruptcy Code § 545. This section, which empowers a trustee to avoid statutory liens that are not perfected at the time of the commencement of the case against a hypothetical bona fide purchaser that purchases the property at that time,\textsuperscript{128} addresses state-created liens that are enforceable only in bankruptcy.\textsuperscript{129} Inasmuch as the policy underlying the statutory-lien avoidance power in § 545 has no application to Article 9 security interests, it should come as no surprise that Congress expressly excluded security interests from the definition of “statutory lien.”\textsuperscript{130}

2. Should a Trustee’s Strong-Arm and Preference Avoidance of Security Interests in Personal Property and Fixtures Be Conformed to the Trustee’s Bona Fide Purchaser Status Applicable to Real Property?

The idea of giving a trustee in bankruptcy the rights and powers of a good-faith purchaser is not a new one. The trustee already enjoys

\textsuperscript{126} See U.C.C. § 9-320(a) (buyer in ordinary course of business, as defined in UCC § 1-201(9), takes free of perfected security interest).

\textsuperscript{127} See id. § 9-330(a), (b) (priority of purchasers of chattel paper who take possession in the ordinary course of business).

\textsuperscript{128} Section 545 empowers a trustee to avoid statutory liens that are “not perfected or enforceable at the time of the commencement of the case against a bona fide purchaser that purchases the property at the time of the commencement of the case, whether or not such a purchaser exists.” Bankruptcy Code § 545(2).

\textsuperscript{129} See TABB, supra note 51, at 463 (“a state statutory lien that has a priority effect will be enforced in bankruptcy if it is bankruptcy-neutral”). Even if § 545(2) is also viewed as implementing the policy against “secret liens,” see id., it does not justify widespread avoidance of security interests. See infra note 145 and accompanying text.

\textsuperscript{130} “[S]tatuory lien”... does not include security interest, whether or not such interest... is provided by or is dependent on a statute and whether or not such interest... is made fully effective by statute.” 11 U.S.C. § 101(53). “[S]ecurity interest’ means lien created by agreement.” See id. § 101(51).

One might imagine a more modest version of the most-favored-claimant avoidance power, the “most-favored-secured-party” avoidance power, which would arm the trustee in bankruptcy with the rights of a hypothetical secured party who holds a security interest in the same collateral in which an actual secured party has perfected an otherwise unavoidable security interest. Although narrower in scope than the most-favored-claimant avoidance power, the most-favored-secured-party avoidance power is likewise not supported by any theory or policy immanent in the existing avoidance powers or otherwise.
those rights with respect to prepetition transfers of real property, other than fixtures.\textsuperscript{131} Substantially the same good-faith (bona fide) purchaser test applies under § 547(e)(1) for determining when a transfer of real property, other than fixtures, is perfected (which, in turn, determines when a transfer is made) for the purpose of preference avoidance.\textsuperscript{132} Would the goal of conforming the avoidance powers for transfers of personal property and fixtures to the powers applicable to transfers of real property provide a rational and appropriate justification for Section 103? We believe the answer is no.

The history of § 544(a)(3) is instructive in this regard. Bankruptcy trustees could not exercise the powers of a bona fide purchaser of real property under the strong-arm clause of the Bankruptcy Act of 1898 ("Bankruptcy Act").\textsuperscript{133} This power was added to the strong-arm clause in 1978 with the enactment of Bankruptcy Code § 544(a)(3). The change was much less significant than it might first appear. Essentially the same result—the avoidance of unrecorded mortgages—often was achieved under the Bankruptcy Act’s preference avoidance power, section 60.\textsuperscript{134} Section 60a(2) of the Bankruptcy Act provided that a transfer of real property occurred when the transfer was “so far perfected” that it became invulnerable to the rights of a bona fide purchaser.\textsuperscript{135} If a transfer was never so perfected, it was “deemed to have been made immediately before the filing of the [bankruptcy] petition.”\textsuperscript{136} The result was that a transfer vulnerable to the rights of a hypothetical bona fide purchaser at the time a bankruptcy petition is filed fell within the then-applicable four-month preference period. If the other elements of a “preference” under section 60a(1) were satisfied, the transfer might be avoidable under section 60b.\textsuperscript{137} By adding § 544(a)(3) to the strong-arm avoidance power, the Bankruptcy Code generally conformed the strong-arm and preference bona fide purchaser tests for transfers of real property other than fixtures.\textsuperscript{138}

\begin{footnotes}
\item \textsuperscript{131} See id. § 544(a)(3) (bankruptcy trustee has the rights and powers of a hypothetical bona fide purchaser of real property, other than fixtures, from the debtor).
\item \textsuperscript{132} See id. §§ 547(e)(1) (fixing time when perfection of transfer of real property other than fixtures occurs); 547(e)(2) (determining when a transfer is made by reference to whether and when the transfer is perfected).
\item \textsuperscript{134} See id. § 60, 11 U.S.C. § 96.
\item \textsuperscript{135} Id. § 60a(2), 11 U.S.C. § 96a(2).
\item \textsuperscript{136} Id. Bankruptcy Code § 547(e)(2)(C) is to a similar effect. See 11 U.S.C. § 547(e)(2)(C).
\item \textsuperscript{137} See Bankruptcy Act § 60a(1), b, 11 U.S.C. § 96a(1), b (1976) (repealed effective Oct. 1, 1979). Preferential transfers avoidable under the Bankruptcy Act were those that (1) were made within the four-month period prior to the filing, "for or on account of an antecedent debt," and while the debtor was insolvent and (2) enabled the creditor to obtain a greater recovery than other creditors of the same class. Bankruptcy Act § 60a(1), 11 U.S.C. § 96a(1) (1976) (repealed effective Oct. 1, 1979).
\item \textsuperscript{138} Under section 60b a preference could be avoided only if at the time of the transfer "the creditor... has... reasonable cause to believe that the debtor is insolvent." See Bankruptcy Act
\end{footnotes}
The difference between the test applied to transfers of personal property and fixtures (i.e., the judicial lien creditor test) for purposes of the strong-arm and preference avoidance powers, and the test applied to transfers of real property (i.e., the good-faith purchase test) generally reflects differences in state law relating to personal property and fixtures on one hand and real property on the other. In many jurisdictions a transfer of real property, such as by deed or mortgage, is valid against claims of the transferor's judicial lien creditors even if the transfer is not recorded in the proper real estate records. Consequently, if a trustee were given only the rights and powers of a hypothetical judicial lien creditor with respect to a transfer of real property, many secret, unrecorded transfers of real property would be invulnerable to avoidance. The bona fide purchaser test for real property then, effectively reflects a policy against secret liens and other transfers and in favor of publicity.

If any conformity is desirable, Section 103 has it backwards. The strong-arm and preference powers for transfers of real property should be conformed to those applicable to personal property and fixtures, as opposed to the other way around. Aside from fraud (actual or constructive), there would seem to be no bankruptcy policy against secret liens and thus no reason to arm a trustee with the power to avoid them if they cannot be avoided by creditors outside bankruptcy. In contrast, applying a good-faith purchaser test to transfers of personal property and fixtures would have disastrous effects on the credit markets, for the simple reason that certain distinct good-faith purchasers of personal property and fixtures have such powerful rights against even perfected security interests. As the Report explained:

a bona fide purchaser test for determining when a transfer of


139 See COLLIER ON BANKRUPTCY, supra note 64, ¶ 547.06[1], at 547-84.

140 Section 547(e) puts a premium on prompt performance of whatever act is necessary under local law to perfect a transfer of real property. This encourages open dealing and safeguards the debtor's general creditors from the problem created by the perfection of secret liens shortly before the debtor files a petition for relief under title 11. COLLIER ON BANKRUPTCY, supra note 64, ¶ 547.06[3], at 547-85. Accord TABB, supra note 61, § 6.4, at 341 ("The probable intention of Congress [in enacting 11 U.S.C. § 544(a)(3)] was to deal broadly with the whole problem of ostensible ownership.").

141 TABB, supra note 61, § 6.4, at 341 ("The difficulty is that there is no obvious bankruptcy policy that dictates resolving the ostensible ownership issue differently inside a bankruptcy case than it is under nonbankruptcy law."). The best solution to the problem of secret real-property interests might be to reform nonbankruptcy law to afford judicial lien creditors rights with respect to unrecorded transfers. Cf. U.C.C. § 9-317(a)-(d) (providing that an unperfected security interest in personal property and fixtures generally is subordinate to the rights of judicial lien creditors, buyers, lessees, and licensees).

142 See supra discussion Part I.A.
personal property occurs for preference purposes was abandoned
more than 50 years ago because it did not work and substantially
impeded the development and use of secured credit. In 1950,
Congress amended the Bankruptcy Act so as to override the
(in)famous case of *Corn Exchange National Bank v. Klauder.*

The then effective Bankruptcy Act conferred on the trustee, in
exercising its power to avoid preferences, the rights of a hypothetical
bona fide purchaser of personal property (assigned accounts
receivable, in *Klauder*). *Klauder,* in effect, also gave the trustee the
rights of a hypothetical purchaser that was the first assignee to give
notice to the underlying account obligor. From the 1950 amendment
forward, the test for transfers of personal property in the context of
preference avoidance has been based on the priority of a hypothetical
judicial lien creditor.

In sum, even if the good-faith purchaser test is justified for real
property, differences between the law of real property and the law of
personal property and fixtures make the test inappropriate for transfers
of the latter.

III. LESSONS FROM THE AUSPICIOUS BEGINNINGS AND IGNOMINIOUS
DEMISE OF SECTION 103: COMPETENCE, INTEGRITY, AND TRANSPARENCY
IN LAW REFORM

In the preceding Part we sought, without success, to identify a
plausible rationale for an expansion of the trustee’s avoidance powers
either along the lines of Section 103 or along the narrower lines of the
sponsors’ explanation of the section. In this Part we suggest possible
failures in the legislative process that may have led to this flawed
legislation and to the striking conflict between the expression of the
sponsors’ intentions and the effects of the Bill as introduced.

Section 103 is not the first poorly conceived, ill-advised, and badly
drafted legislation introduced in Congress, and, no doubt, it is not the
last. From one perspective, the legislative process worked. The
eventual failure of the Bill, and Section 103 in particular, provides an
eexample of a successful effort to oppose the enactment of unwise
legislation. Yet the costs of resistance were high. A large number and
wide range of interested organizations and individuals spent a great
amount of time at considerable expense to thwart the bill. Lobbyists
and lawyers do not come cheap. Even regulators within the federal
government found it necessary to forge a prompt, coordinated response
to explain to the sponsors that the legislation would wreak considerable

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143 318 U.S. 434 (1943).
144 REPORT, supra note 12, at 13 (some footnotes omitted).
harm to the very employees whom the sponsors claimed they wished to protect. The legislative process would have worked much better had Section 103 never been introduced or been scheduled for a committee hearing.

What went wrong? What lessons should we take from the introduction and eventual withdrawal of Section 103? We identify three aspects of this failure of the legislative process that may suggest useful lessons for those involved with law reform-related activities: competence, truthfulness, and transparency.

The individuals who participated in the drafting and review of Section 103 may have intended to craft a provision that merely would have rolled back the clock on Article 9 for purposes of the avoidance powers. If so, they certainly failed in their efforts. This raises a question of competence in drafting. Even more worrisome is the fact that anyone who understood Section 103 would have known that the sponsors’ stated explanation of its purpose was not correct. Any belief that Section 103, as drafted, was consistent with that explanation also would suggest a lack of competence, in understanding how the provision actually would work and how it would affect routine financing transactions.

Alternatively, the conflict between the sponsors’ explanation of Section 103 and its substance raises question of truthfulness and candor. We have no means of determining the sponsors’ subjective motivations for including Section 103 in the bill. From an objective perspective, however, there is reason to be skeptical that benefits for employees and retirees had much to do with the section, except perhaps in the most simplistic sense discussed above. Even if Section 103 would have freed up assets by avoiding security interests, these assets would have become available to satisfy all claims, not just the claims of employees and retirees. Viewed in this light, both Section 103 as originally proposed and the narrower versions discussed above can be seen as a direct assault on security interests, an assault that is unrelated to the interests of employees and retirees.

One might ask: If the sponsors actually believed that greater powers to avoid security interests would be best for employees and retirees (or anyone else), why then did Section 103 attack security interests only indirectly (through the hypothetical reliance purchaser relying on hypothetical incorrect information) rather than scale back

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145 See Letter from Paul H. O’Neill et al., supra note 17.
146 See supra note 94.
147 As we explain elsewhere, we doubt that it would have had that effect in any large measure going forward. See supra text following note 95. However, if Section 103 were enacted and its proposed retroactive application were upheld as constitutional, the Section might have had that effect in the case of pre-enactment secured transactions rendered avoidable by the retroactive effect.
secured claims more directly and straightforwardly?

One answer may be that measuring avoidance powers by using the rights of a hypothetical nonbankruptcy claimant would be more in keeping with the traditions of the Bankruptcy Code.\textsuperscript{148} However, motives apart from the desire for statutory consistency may have been involved. Those who drafted Section 103 may have chosen to invoke the rights of a hypothetical good-faith purchaser to give the appearance of pursuing a principle different from a simple scale-back. An indirect attack would be more difficult to discover than a direct frontal assault. It is not inconceivable that UCC sections 9-338 and 9-312(a) may have been used as cover for the sponsors’ claim that the purpose of the section was merely to return to the status quo ante under Former Article 9.\textsuperscript{149}

We have been led to believe that some individuals involved in the process reasonably relied on others whom they believed to be competent and reliable. It may be that this reliance was misplaced, and that one or more otherwise competent individuals produced an unsatisfactory product or gave poor advice. It may also be that some individuals involved with Section 103 were quite competent but intended the broad impact that Section 103 actually would have had on secured financing rather than the comparatively modest effects claimed by the sponsors. We have been told that the sponsors of the Bill and some of their staff were surprised by the strength of the opposition to Section 103 and several other provisions of the Bill. This surprise may have resulted from the failure of the sponsors and their staffs to understand the wide impact that Section 103 would have imposed on routine transactions.\textsuperscript{150} The possibility that people upon whom the sponsors and their staff relied were not forthcoming in disclosing their intentions raises yet another question of candor.\textsuperscript{151}

Did someone fail to forthrightly inform the sponsors and their staff members about the true nature of Section 103? It is certainly possible that Section 103 was proposed and supported by bankruptcy experts who opposed Revised Article 9 and who wished to render many secured

\textsuperscript{148} See, e.g., 11 U.S.C. §§ 544(a), 547(e).

\textsuperscript{149} See generally supra discussion Part I (discussing the inconsistency between Section 103 and the sponsors’ claim that the section rolls back the revisions to UCC Article 9).

\textsuperscript{150} The fact that Senator Durbin has shown sensitivity to the concerns of businesses, including the small businesses that would have been likely to suffer had Section 103 been enacted, lends support to this hypothesis. See Mike Dorning, Senators reverse roles on business; Fitzgerald, Durbin buck party trends, CHI. TRIB., Aug. 26, 2002, at News 1 ("The liberal Durbin, son of a stevedore and a longtime ally of organized labor, increasingly is seen by many Illinois business leaders as the go-to man to represent their interests in the Senate."). Some earlier bankruptcy reform efforts by Senator Durbin did not reflect the attitude reflected in Section 103. See, e.g., Consumer Bankruptcy Reform Act of 1998, S. 1301, 105th Cong. (1998); Consumer Bankruptcy Reform Act of 1999, S. 945, 106th Cong. (1999).

\textsuperscript{151} This also implicates the competence of the sponsors and staff members in their failure to appreciate the effects of Section 103 based on their own knowledge and experience.
transactions less effective, if not ineffective, in bankruptcy, thereby
snatching victory from the jaws of the past defeat.\footnote{152} This hypothesis
finds at least some support in the Final Report of the National
Bankruptcy Review Commission and in the process leading up to the
Final Report.\footnote{153} The fact that the Commission’s recommendations
make little mention of the avoidance powers provides strong evidence
that responsible, mainstream bankruptcy professionals and academics,
at least, saw no need for a material expansion of those powers.\footnote{154} We
also have no reason to believe that the Commission had any concerns
about the direction of Revised Article 9, the details of which (including
the substance of what became section 9-338) were in the public domain
as the Commission finalized its report in 1997.\footnote{155}

\footnote{152} The defeat, of course, was the overwhelming rejection of the opponents’ complaints about
Revised Article 9. As the Report noted:

Following its unanimous approval in 1998, it was presented to the legislatures for
adoption, a process that normally takes 8 to 10 years. Because of the strong national
support, the need for immediate adoption, and the lack of any organized opposition to
the changes, Revised UCC Article 9 was adopted by the legislatures in all 50 states and
by the District of Columbia by July 1, 2001, and is now effective in all 50 states, the
District of Columbia, and the U.S. Virgin Islands. Indeed, Revised UCC Article 9
enjoys the fastest adoption record in the more than 100-year history of the National
Conference. Article 9 has been considered the “crown jewel” of the UCC for almost
50 years, being the most bold and innovative of the UCC’s articles. Why would the
United States Congress wish to flout this important and successful domain of state
law?

\footnote{153} National Bankruptcy Review Commission Final Report, Bankruptcy: The Next
Twenty Years (1997) [hereinafter NBRC Report].

\footnote{154} To the contrary, the Report noted that the NBRC Report recommended restricting the
avoidance powers. See REPORT, supra note 12, at 13 & n.21, citing NBRC REPORT, supra note
153, Recommendations 3.2.1 at 797-98 (transfers of less than $5,000 may not be sought in action
to avoid nonconsumer debt preference); 3.2.2 at 799-800 (preference recovery action of less than
$10,000 must be brought in district in which transferee has principal business); 3.2.3 at 800-03
(strengthening protection from preference avoidance for ordinary-course payments); 4.2.11 at 955
(cut back on Bankruptcy Code § 545(2) bona fide purchaser test to provide federal tax lien
greater protection from avoidance).

\footnote{155} As the Report explained:

Moreover, the Commission must have been aware of the status of the planned revisions
to UCC Article 9. By 1997 most of the substantive proposals already were on
the table. For example, a provision substantially similar to UCC § 9-338 was included as §
9-335 in the 1997 drafts of the revised Article presented to The American Law Institute
and the National Conference of Commissioners on Uniform State Laws.
Our conjectures concerning the competence or truthfulness of those involved with formulating and proposing Section 103 make us uncomfortable, but we know of no other means of exploring the possibilities for how the provision came to be. Understanding the process may make it less likely that the same mistakes will be made in the future, and avoiding future repeat performances is the chief point of our exercise.156

Although it appears that the sponsors eventually came to appreciate the enormity of the detrimental impact that Section 103 and some other provisions of the Bill would have had,157 their approach was structured in a way that discouraged constructive debate and sheltered the process from essential expertise. A more transparent process would have attracted the attention of experts, such as the authors of the Report, earlier in the process. Had that occurred, it is unlikely that Section 103 would have been included in the Bill. Section 103 was drafted behind the scenes. If the Bill is a fair example, and we believe that it may be, then cronyism is alive and well in the world of bankruptcy law reform.158 To the best of our knowledge Section 103 was introduced before the sponsors and their staff members consulted with organizations of bankruptcy professionals or organizations representing either the users or extenders of secured credit. Although the Bill was introduced on July 25, 2002, the sponsors’ first public statements on it were not issued until August 1, 2002, immediately before Congress was to adjourn until after Labor Day.159 August is, of course, a time when many vacations are scheduled; it is hard to imagine a period, other than year’s end, during which collective action in opposition to legislation would be more difficult to organize.160 Moreover, on August 28, 2002, the bill was scheduled for a hearing on September 5 before the full

REPORT, supra note 12, at 14 n.20. During the Article 9 drafting process the Chair of the Article 9 Drafting Committee, William Burke, offered (for himself and on behalf of the Reporters) to meet with or testify before the Commission about the revision. That the offer was not accepted strongly suggests the absence of concern.

156 The sponsors and their staff members know whom they relied upon for advice concerning Section 103. They may elect to seek broader expert input in the future. One Congressional staff member indicated to one of the authors of the Report that neither the staffer nor the legislator for whom the staffer works would again propose to modify the avoidance powers without first consulting experienced experts in the field of secured transactions.


158 The enormous influence of bankruptcy professionals in the bankruptcy-related legislative process over the years is well known. See David A. Skeel, Jr., Debt’s Dominion: A History of Bankruptcy Law in America 14-16, 80-98 (2001).

159 See supra note 11.

160 Perhaps surprisingly, the authors of the Report were able to produce it by the day following Labor Day.
Senate Judiciary Committee—affording barely more than a week’s notice to the public.\footnote{Of this week, the Labor Day weekend and the Friday preceding it comprised four days.} Happily, the sponsors came to appreciate the strength and power of the opposition to the bill and canceled the hearing.\footnote{Notice of Full Committee Hearing Postponement (Sept. 3, 2002), at http://www.senate.gov/~judiciary/hearing.cfm?id=395.} Bankruptcy law is both highly technical and very important; it has an enormous impact on transactions and behavior outside bankruptcy. We would have hoped for a more considered approach from our elected officials.\footnote{To be sure, we personally have been spoiled by our experiences with the law reform processes of the National Conference of Commissioners on Uniform State Laws and The American Law Institute.}

Are there possible solutions that would avoid or render less likely another Durbin-Delahunt-like fiasco? We believe that it is worthwhile for the organizations of bankruptcy professionals to explore this question. We can imagine a system for a thorough vetting of all proposals to modify the Bankruptcy Code. One model is the formal judge-lawyer partnership structure for creating and modifying federal rules of practice, procedure, and evidence.\footnote{For a summary of the process under which these rules are promulgated, see The Rulemaking Process, on the website of the Judicial Conference of the United States, http://www.uscourts.gov/rules/proceduresum.htm. The Judicial Conference's work is coordinated by its Committee on Rules of Practice and Procedure, often called the "Standing Committee." \textit{Id.} The Standing Committee considers proposals for revision made by one of the five advisory committees (appellate, bankruptcy, civil, criminal, or evidence). \textit{Id.} With the Standing Committee's approval, an advisory committee may circulate proposals to lawyers and judges for comment and hold public hearings. \textit{Id.} When the Standing Committee approves a recommendation for an amendment and the Judicial Conference, in turn, approves the Standing Committee's recommendation, the Judicial Conference reports the recommendation to the Supreme Court by May 1. \textit{Id.} If the Supreme Court adopts the amendment it then transmits the amendment to Congress, which can reject, modify, or defer the amendment. \textit{Id.} Absent Congressional action, the amendment becomes effective on the following December 1. \textit{Id.} The National Bankruptcy Review Commission embodies another approach, but it was not successful in achieving any meaningful reform.} Congress could create, for example, a standing committee supported by more specialized advisory committees, each populated by lawyers, judges, and academics. These committees would make recommendations on revisions of the Bankruptcy Code and comment on proposals for revision, taking into account input solicited from the public.\footnote{For decades the National Bankruptcy Commission ("NBC") has studied he operation of bankruptcy and related laws and proposals for their reform. \textit{See} National Bankruptcy Conference, Mission, available at http://www.nationalbankruptcyconference.org. (last visited Feb. 14, 2004). However, the NBC has no formal role in the legislative process.} While Congress could not guarantee not to reverse its course, such a system could contain powerful disincentives for Congress to ignore it by enacting "end-run" legislation.
CONCLUSION

Section 103 of the Bill began with a bang, and died with barely a whimper. There is, however, more to the story than the proposal, and eventual abandonment, of unwise legislation. In the end the sponsors and their staffs realized, we surmise, that Section 103 was ill-conceived and that they had been blindsided by some flawed advice.

As academics we take very seriously our role in the process of law reform on every level, whether we act in an official or informal capacity. As academics we believe that we must use our knowledge carefully and guard our professional reputations tenaciously. In giving advice and counsel to lawmakers we should observe a level of care and objectivity that is every bit as high as the duties that would apply in the representation of a client. We should not fear to offer our views publicly and candidly. These are the standards and values that we and our fellow co-authors of the Report brought to the project. We hope that our participation may have at least some small but lasting influence with the Bill's sponsors and their staffs as well as on the continuing process of reforming bankruptcy law.
REPORT ON AVOIDANCE, SUBORDINATION, SUPER PRIORITY, AND RECHARACTERIZATION PROVISIONS OF THE PROPOSED EMPLOYEE ABUSE PREVENTION ACT OF 2002

September 3, 2002

Submitted in our individual capacities:

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<thead>
<tr>
<th>William M. Burke, Esq.</th>
<th>William H. Schorling, Esq.</th>
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<tr>
<td>Shearman &amp; Sterling</td>
<td>Klett Rooney Lieber &amp; Schorling</td>
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<tr>
<td>New York, NY</td>
<td>Philadelphia, PA</td>
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<th>Duane M. Geck, Esq.</th>
<th>Steven L. Schwarcz</th>
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<td>Professor of Law</td>
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<td>Chicago-Kent College of Law</td>
<td>Cardozo School of Law</td>
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<th>Edwin E. Smith, Esq.</th>
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<th>Jeffrey S. Turner, Esq.</th>
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<td>Heller Ehrman White &amp; McAuliffe LLP</td>
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I. EXECUTIVE SUMMARY

Senator Richard J. Durbin (D-IL) and Rep. William D. Delahunt (D-MA) introduced the Employee Abuse Prevention Act of 2002 (S. 2798 and H.R. 5221) (the "Act") on July 25, 2002. The stated purpose of the Act is to provide additional protections for "employees and retirees from corporate practices that rob them of their earnings and retirement savings when businesses collapse into bankruptcy." That is a laudable goal and we applaud the sponsors' efforts and concerns. This report does not address the provisions of the Act that deal directly with those corporate practices. Instead, this report limits its focus to three especially troubling provisions of the Act that are designed to override important aspects of state law. These provisions are not directed to the corporate practices that are the principal focus of the Act.

The provisions of the Act addressed here would materially amend the Bankruptcy Code ("BC"). In doing so, they would impose significant constraints on state laws and have a substantial and adverse effect on the economy. Significantly, these provisions would impede future transactions and would be applied retroactively to invalidate property rights in existing transactions in which billions of dollars of credit have been extended to both business enterprises and consumers.

First, the Act would confer on a trustee in bankruptcy considerably expanded avoidance powers with respect to a debtor's pre-bankruptcy transfers of property, including security interests in personal property. Second, the Act would subordinate secured claims to certain new administrative expense priority claims and create a "super" priority for the new priority claims.

These two sets of provisions would significantly impair in bankruptcy many nonpossessionary and possessionary security interests in personal property. These changes would effectively repeal, immediately and retroactively, much of Uniform Commercial Code (UCC) Article 9, thus relegating secured transactions law in the United States to the genre of legal regimes that exist in many developing countries, with the corresponding impediments to financing and capital formation. This repeal would come not long after all 50 states, the District of Columbia, and the U.S. Virgin Islands adopted changes to UCC Article 9 intended to modernize the statute to facilitate the capital formation that is so crucial to the health of our national economy. Indeed, the sponsors indicate that the expanded avoidance powers in the Act are specifically intended to override certain of these changes to

165166 See Section-By-Section Summary at 1.
UCC Article 9. The proposed avoidance powers in the Act go far beyond negating the recent changes made to UCC Article 9. They would render UCC Article 9 largely without effect to support extensions of secured credit because many secured transactions would not be effective in bankruptcy.

Third, the Act would federalize the question whether a pre-bankruptcy sale, lease, or other transfer of property is to be recharacterized as a secured loan, replacing generally applicable and settled state law with a vague federal test. For example, an outright (or "true") sale of property removes the property from a debtor's estate and should be effective and nonavoidable if made in exchange for reasonably equivalent value. Under most state laws, transactions that nominally are sales may, in appropriate cases, be recharacterized as transfers of an interest in property that is less than complete and outright ownership. When state law does not permit such a recharacterization, federal courts in bankruptcy cases already have the power to adjust state law when required to advance a significant federal interest. The new federal test for recharacterization would introduce substantial uncertainty for a variety of commercial transactions that have been used as a source of capital and liquidity for businesses.

Part II of this report summarizes its conclusions. Parts III through V address the substantive proposals mentioned above. In each case the discussion explains how the provisions of the Act probably would be interpreted and applied, the likely transactional and economic impact of the provisions, and the merits of the proposals in the context of well-accepted bankruptcy policies and history. Part VI addresses the Act's proposed immediate effectiveness and retroactive application. Part VII then considers the importance of thorough, well-publicized legislative hearings on this bankruptcy legislation before adoption of the Act or any of its provisions. Part VIII concludes the report.

The following analysis of the relevant provisions of the Act seeks to identify the most plausible interpretation of the Act.

II. SUMMARY OF CONCLUSIONS

The trustee's expanded avoidance powers under the Act would:

- essentially eliminate nonpossessory secured transactions (and probably possessory secured transactions) in virtually all areas of personal property financing, including the financing of inventory, intangibles such as receivables, securities, and other investment property, and equipment;

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167 See Section-By-Section Summary at 2.
effectively repeal UCC Article 9 (as recently revised and enacted in substantially the uniform version in all 50 States, the District of Columbia, and the U.S. Virgin Islands) and deprive the United States of a modern law on secured transactions (as opposed to nullifying recent amendments to UCC Article 9, as claimed by the sponsors);
reduce the availability and increase the cost of credit, thus imposing significant costs on a wide range of businesses and individual consumers;
have a substantial and adverse effect on the economy; and
conflict with well-accepted theoretical and historical bankruptcy policies on the appropriate role of avoidance powers.

Even if the Act were rewritten to address only secured transactions as to which a public registry actually contains incorrect information, it nonetheless would increase costs, have adverse economic effects, conflict with well-accepted bankruptcy avoidance policies, and impair UCC Article 9.

The Act’s provision for subordination of secured claims to new pension-related priority claims and its new super priority rule:
are unclear as to their operation and application;
would place unacceptable burdens on secured financing and raise the cost of credit; and
do not reflect a sound or balanced bankruptcy policy.

The Act’s federal test for recharacterizing pre-bankruptcy transfers of property:
provides no guidance on the factors relevant to recharacterization, leaving the courts with no principled basis to evaluate transfers;
provides the courts with unbridled and dangerous discretion to recharacterize transfers that have been structured and negotiated between parties to legitimate commercial transactions,
is unnecessary because (i) state law, as interpreted by the courts, normally provides sufficient guidance and has worked well in determining when transfers should be recharacterized and (ii) federal courts already have the power to adjust state property law if required to protect a compelling federal interest; and
would create substantial and undesirable uncertainty for:
securitization transactions (including those involving sales of residential mortgage loans) and other transactions in which sales of financial assets take place, thereby reducing the availability and increasing the cost of credit and funding; and
virtually all transfers of real and personal property, including leases, licenses, consignments, and other bailments.
would have a substantial and adverse effect on the economy.
The Act’s provision for immediate and retroactive effectiveness is
unfair and unnecessary and would upset fixed and vested rights and interests, including property interests.

Neither Congress nor any of its Committees should take action on the Act or any of its provisions until open hearings have been held, after well-publicized notice, and all interested parties have been given the opportunity to be heard.

III. PROPOSED AVOIDANCE PROVISIONS

A. Description, Application, and Interpretation

1. BC § 544(a) “Strong Arm” Avoidance Power

Section 103(a) of the Act would amend BC § 544(a) (the trustee’s so-called “strong arm” power) to add a new paragraph (4). The new provision would give a trustee the rights of a hypothetical good faith purchaser of property who (i) gave value, (ii) relied on incorrect information in a public record, and (iii) either (x) took possession of the property (even if it could not be possessed) or (y) took steps to make the purchaser’s interest invulnerable to a judicial lien creditor. The trustee would have those rights even though no such purchaser actually existed168 and even if no incorrect information on a public record existed. The hypothetical purchaser could be either an outright buyer or another secured party receiving a security interest. Under current BC § 544(a)(1), the trustee only has the rights of a hypothetical judicial lien creditor as to personal property and fixtures on the date bankruptcy commences.169

The principal effect of the new avoiding power would be to render most nonpossessory security interests vulnerable to avoidance by a trustee. This proposal is an enormous expansion of rights of a trustee beyond those that exist under current law as to personal property and fixtures.

Consider an example:

Example 1. Dealer obtains a loan from Lender and grants to Lender a security interest in its inventory of goods and in its rights to payment for goods that it has sold or leased, as evidenced by installment sales contracts and leasing agreements with Dealer's

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168 We read the reference to “such creditor” in proposed new BC § 544(a)(4)(C)(1) to mean “such purchaser.” This gives effect to the apparent intent and, otherwise, there would be no antecedent to which “such” could refer.

169 Under current BC § 544(a)(3) the trustee has the rights of a good faith purchaser of real property, but not of personal property or fixtures. This distinction is considered below.
customers. Lender perfects its security interest under UCC Article 9 by filing a proper financing statement in the appropriate public filing office. One year later Dealer files a bankruptcy petition.

The perfected status resulting from public notice (Lender’s filing of the financing statement) affords Lender priority over a later-in-time judicial lien creditor of the debtor. It also protects Lender’s security interest from avoidance under current BC § 544(a)(1). Under the Act’s new BC § 544(a)(4), however, the trustee could avoid Lender’s perfected security interest, as to which Lender had proceeded correctly in all respects including the filing of a financing statement in the correct public office containing correct information. As to the inventory on hand, the trustee’s new hypothetical good faith purchaser status would afford it the right of a “buyer in ordinary course of business,” to buy the inventory free of Lender’s security interest. As to the installment sales agreements and leasing agreements (denominated “chattel paper” under UCC § 9-102(a)(11)) generated when Dealer sells the inventory, the trustee would have the rights of an ordinary course purchaser of the rights to payment under the chattel paper who has taken possession of the chattel paper and given new value in order to achieve priority over the Lender. Lender’s only possible means of protecting itself against a future bankruptcy of Dealer would be to take physical possession of Dealer’s inventory and chattel paper—a step that would be practically impossible in the case of most inventory financing and that often is not practical in the case of chattel paper.

Arguably, even Lender’s taking possession of the inventory and chattel paper would not protect it from the trustee’s proposed enhanced avoidance powers. Because the Act’s new BC § 544(a)(4) hypothesizes that the trustee takes possession of the collateral, it might be read to imply that Lender no longer holds possession itself. The same reasoning might be applied to secured party that has “control” of intangible assets such as uncertificated securities or security entitlements, even if actual possession were impossible. This reading would negate Lender’s actual possession or control in favor of the trustee’s subsequent hypothetical possession. On this reasoning even security interests perfected by possession or control would be vulnerable in bankruptcy.

170 UCC § 9-317(a).
171 UCC § 9-320(a).
172 UCC§ 9-330(a), (b). In like manner, the Act’s new BC § 544(a)(4) also would permit avoidance of security interests perfected by filing in instruments (such as promissory notes), documents of title, and securities. UCC §§ 9-330; 9-331. Note that most of the good faith purchase rules discussed in this section (UCC §§ 9-320, 9-330, and 9-331) had very similar antecedents that would have produced identical results under former (i.e., pre-revision) UCC Article 9. See former UCC §§ 9-307; 9-308; 9-309.
173 See, e.g., UCC §§ 9-331 (rights of purchasers of instruments, documents, and securities
The Act’s expansion of the trustee’s strong arm avoidance power is even broader than indicated above. Consider another example:

**Example 2.** Manufacturer obtains a working capital loan from Lender and grants to Lender a security interest in Manufacturer’s equipment. Lender perfects its security interest by filing a proper financing statement in the appropriate filing office. One year later Manufacturer files a bankruptcy petition.

Once again, Lender has taken all appropriate steps to perfect its security interest by filing, but under the Act’s new BC § 544(a)(4), the trustee is entitled to avoid Lender’s security interest. This is because the trustee is armed with hypothetical reliance on hypothetical incorrect information in the filing office. The trustee may rely on the rights of a purchaser relying on incorrect information to take free of a security interest under UCC § 9-338(2).

One possible interpretation of proposed new BC § 544(a)(4) is that it addresses, and is intended to address, only the rights of a good faith purchaser who has relied on incorrect information under UCC § 9-338(1) and (2). Even if the language is so limited, the Act nonetheless would give the trustee the rights of a hypothetical good faith purchaser who hypothetically relied on hypothetical incorrect information in a filed financing statement. Having these rights, the trustee would be able to avoid correctly perfected security interests that had been perfected by filing. In Example 1, the trustee would still be able to avoid the correctly perfected security interests in inventory and chattel paper.

These examples do not reflect a complete account of the problems and do not exhaust the circumstances in which the trustee’s enhanced avoidance powers could be exercised under the Act’s proposed new BC § 544(a)(4). There are several other circumstances under UCC Article 9 in which, under the proposed expanded strong arm power, a trustee could exercise the rights of a good faith purchaser to avoid properly perfected security interests.

2. BC § 547 “Preference” Avoidance Power

Section 103(b) of the Act would change the rule for determining when a transfer is made for purposes of avoiding preferential transfers. Under current BC § 547(b) transfers made by an insolvent debtor to a non-insider within 90 days before a bankruptcy filing and on account of an antecedent debt generally are avoidable. A somewhat complex statutory system for determining when a transfer is made is found in BC § 547(e). The timing of a transfer is important for determining both

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under UCC Articles 3, 7, and 8); 9-328(1) (control priority).
whether the transfer was made within the 90-day window and for determining whether the transfer was for an antecedent debt. Under BC § 547(e)(2), the timing of a transfer is a function of whether and when a transfer is "perfected." For personal property and fixtures, a transfer is perfected when it is invulnerable to a judicial lien obtained by a creditor on a simple contract.\textsuperscript{174} (This is essentially analogous to the judicial lien creditor test for personal property and fixtures in current BC § 544(a)(1), discussed above.) The Act would change the results in bankruptcy significantly by substituting a good faith purchaser test for the judicial lien creditor test. This would mean, for example, that a security interest perfected under UCC Article 9 would not be perfected for purposes of preference avoidance so long as the security interest were vulnerable to the claim of a superior good faith purchaser.

Example 3. Vendor sells a consumer appliance to Consumer on credit under an installment sales agreement in which Vendor obtains a security interest in the goods to secure the unpaid price. Sixty days later Consumer files a bankruptcy petition.

Under UCC § 9-309(1), Vendor’s security interest is perfected automatically, without the need to file a financing statement or otherwise give public notice, because it is a purchase-money security interest in consumer goods. Because Vendor’s security interest is perfected under UCC Article 9, Vendor’s security interest has priority over a judicial lien creditor of Consumer. The security interest would not be avoidable under BC § 547(b) because it was perfected under current BC § 547(e)(1)(B) when it was created and therefore was not on account of an antecedent debt.\textsuperscript{175} But, under the Act’s version of BC § 547(e)(1)(B), even though Vendor complied in every respect with UCC Article 9, the security interest was never perfected for preference avoidance purposes because it remained at all times vulnerable to a consumer good faith purchaser under UCC § 9-320(b). Consequently, Vendor’s security interest would be avoidable under the Act because it would be deemed to have been transferred “immediately before the date of the filing of the [bankruptcy] petition” and therefore was on account of an antecedent debt.\textsuperscript{176}

Under UCC Article 9, a secured party with purchase-money security interest in consumer goods who has concern about a good faith purchaser of those goods acquiring superior rights can protect its

\textsuperscript{174} BC § 547(e)(1)(B).

\textsuperscript{175} Alternatively, the security interest would be protected from avoidance under BC § 547(e)(1) (contemporaneous exchange for new value) or (3) (purchase-money security interest).

\textsuperscript{176} BC § 547(e)(2)(C). The security interest also would not be sheltered from avoidance by BC § 547(c)(1) or (3).
security interest by filing a financing statement covering the goods.177 The filing would subject the good faith purchaser of these goods from the consumer buyer to the security interest in the goods. Vendor in Example 3 could ensure that its rights in the goods would be superior to those of a good faith purchaser for value by filing a financing statement. The experience under former Article 9, which contained the same provision, was that purchase-money secured parties rarely filed financing statements in these circumstances because of the low risk that the consumer buyer would wrongfully sell the goods subject to the security interest and the cost savings of not filing a financing statement. The Act would instantly change the cost/benefit analysis by forcing the secured party to go the trouble and expense of filing a financing statement in order to have a security interest that is effective in bankruptcy. These costs would, of course, be passed on to the consumer.

On the same reasoning applied to Example 3, because Lender's security interests in inventory and chattel paper in Example 1 remained vulnerable to good faith purchasers, they also could be avoided as preferences under the Act's proposed revision of BC § 547(e)(1)(B).

Unlike the proposed expansion of the strong arm power in proposed new BC § 544(a)(4), the proposed revision of BC § 547(e)(1)(B) makes no reference to "incorrect information." Consequently, the proposed test for perfection is not limited to the rights of a good faith purchaser relying on hypothetical incorrect information under UCC § 9-338(1) and (2).

B. Transactional and Economic Impact; Rationale

The impact of the proposed revised avoidance powers cannot be overemphasized. In particular, the use of inventory, chattel paper, equipment, and other collateral in business financing is ubiquitous. Each year an enormous amount of credit is extended in business financing transactions in reliance on security interests in these types of collateral. The Act would largely render those security interests ineffective in bankruptcy, thus striking a blow at capital formation. The impact of this de facto repeal of much of UCC Article 9 would be especially harsh for small businesses that lack access to the capital markets and which must rely on secured commercial financing for working capital. Contrary to the stated purposes of the Act, its detrimental effects on the cost and availability of business credit necessarily would seriously harm employees and their employers alike.

177 UCC § 9-320(b).
It would leave the United States essentially without a modern secured transactions law.

While we can speak to the impact that the Act would have on transactions with which we are familiar, we suspect that the businesses that rely on secured credit for their existence will have even more to say on the subject. The central insight here is that the principal negative impact of the proposed new avoidance powers would not be confined to debtors in actual bankruptcies, present and future. Following a period of time (involving disruptions of expectations arising out of the Act’s retroactivity), credit markets would adjust. Thereafter, for example, no lender would make a secured inventory loan once forewarned that the security interest would be avoidable in bankruptcy. Thus, the principal impact by far would be on solvent, healthy debtors that never file a bankruptcy petition. By rendering ineffective in bankruptcy a wide swath of secured transactions, many borrowers and buyers would be unable to obtain needed credit or only could obtain less credit at a much higher cost associated with unsecured credit. That is precisely the result that every state and the District of Columbia sought to avoid when, effective just last year, they adopted Revised UCC Article 9 in order to facilitate secured financing in the United States.

The Act’s negative effect on debtors also is not limited to future debtors. The Act would affect every security interest in existence on the day of enactment. On the day of enactment all secured parties would reevaluate their extensions of credit. Almost all secured parties would conclude that, as a practical matter, the credit they had extended on the assumption that their security interests would be respected in bankruptcy had become unsecured. Virtually all security agreements allow a secured party that reasonably concludes that its security is impaired to accelerate the secured loan, making it payable in full at once. Of course, not all debtors would be able to pay in full instantly. But Lenders most certainly would invoke these provisions to accelerate loans or renegotiate loans to take account of the much higher credit risk associated with the fact that the loans had effectively become unsecured. In the end, debtors would be denied credit or would be obliged to pay the higher interest rates normally charged for unsecured loans. Indeed, given the proposed retroactivity of Title I of the Act, if any serious support for the Act surfaced, creditors might begin the renegotiation process even before enactment.

C. Bankruptcy Policy and History

In addition to the serious potential transactional and economic impact of the proposed avoiding power revisions, the proposals also
conflict with well-accepted and uncontroversial understandings about bankruptcy avoiding powers.

Bankruptcy theoreticians and analysts of bankruptcy history have explored the underlying conceptual bases for the trustee’s strong arm (BC § 544(a)) and preference (BC § 547) avoiding powers. Unsurprisingly, they have not always agreed. For example, there are plausible arguments that the strong arm power derives from the trustee’s role as the representative of creditors, from the collectivist goals and structure of bankruptcy law, from concerns about ostensible ownership and secret liens, or from more than one of these possible justifications. Similarly, as to justifications for preference avoidance, arguments advanced include the deterrence of eve-of-bankruptcy grabs, the goal of creditor equality, and a combination of both factors. Quite possibly there are no clear, overriding theoretical justifications. However, no complete theory and historical account of these avoiding powers is needed in order to understand that the Act’s proposed modifications would push the law far from the mainstream and against the current of conventional wisdom about acceptable bankruptcy policy.

Consider first the trustee’s existing BC § 544(a)(1) strong arm power to avoid transfers that would be ineffective against a hypothetical judicial lien creditor of the debtor in the typical context of a security interest in personal property that is unperfected (under UCC Article 9). Outside bankruptcy, the secured party has rights in the property that are superior to those of the debtor’s unsecured creditors, who have no rights at all. On the other hand, outside bankruptcy and under UCC Article 9, any unsecured creditor has at least the potential to become a judicial lien creditor whose lien would defeat (i.e., subordinate) the unperfected security interest. Upon the bankruptcy filing, however, the automatic stay (and, essentially, the whole structure of the BC) prevents these creditors from acquiring a judicial lien and thereby priming the unperfected secured party. Without something like the strong arm power, those creditors would be deprived of any possibility of realizing anything from the debtor’s encumbered property, a possibility that existed outside bankruptcy.

Under the strong arm power the trustee inherits the power of the hypothetical judicial lien creditor and can avoid the unperfected security interest for the benefit of all unsecured creditors—a potential power held by creditors outside bankruptcy. After avoidance, the former unperfected secured party itself becomes an unsecured creditor. This structure recognizes that before bankruptcy all creditors (except the unperfected secured party) had equal rights. The strong arm power preserves this equality by freeing the property from the security interest of the unperfected secured party for the benefit of the unsecured creditors generally. In effect, if in precise doctrine, upon the filing
of a bankruptcy petition the trustee metaphorically seizes the debtor’s property, obtains rights equivalent to that of a hypothetical judicial lien creditor, and preserves the value for all unsecured creditors.

The strong arm power has been criticized on the basis that it is too favorable to unsecured creditors because the power fails to recognize the clear priority of the unperfected secured party’s interest outside bankruptcy. However, the power nevertheless strikes a fair balance by recognizing that some nonbankruptcy entitlements must yield to the benefits of a collective bankruptcy proceeding.

By conferring the power of a hypothetical good faith purchaser on the trustee, the Act deviates from this well-understood effect of the strong arm power to avoid transfers that were vulnerable to judicial lien creditors outside bankruptcy. In general bankruptcy law respects nonbankruptcy rights and entitlements and does not create new rights. The Act, however, confers on the unsecured creditors benefits that they could not have enjoyed outside bankruptcy. Moreover, it ignores the fact that an entire national system of personal property secured financing and law (one that is the envy of much of the world) has been created and recently revised, updated, and reenacted based on the expectation that transfers of personal property and fixtures will be tested in bankruptcy against a hypothetical judicial lien creditor.178

There is nothing suspect, sinister, or inconsistent with bankruptcy policy about nonbankruptcy priority rules that provide good faith purchasers with rights vis-a-vis a perfected security interest that are greater than the rights of judicial lien creditors. Under both former UCC Article 9 and Revised UCC Article 9, the holder of a security interest is afforded perfected status and, accordingly, protection against judicial lien creditors, even though the security interest may be subordinated or cut off by a subsequent good faith purchaser. This is because, unlike purchasers, judicial lien creditors rarely if ever rely in extending credit on the property subject to their judicial liens. Accordingly and appropriately, UCC Article 9 affords them a weaker status than good faith purchasers vis-a-vis a perfected security interest.

To be sure, the strong arm power to avoid transfers of real property, unlike personal property and fixtures, has been based on a

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178 The same can be said of the similar test for testing the time of transfer in the context of preferences, discussed below. It is interesting that as secured financing practices and law developed during the mid-twentieth century, especially following the Second World War, the development of bankruptcy avoidance law proceeded alongside. See the discussion below of Corn Exchange National Bank v. Klauder, 318 U.S. 434 (1943), and the 1950 amendment of the former Bankruptcy Act. This may account for the fact that some prominent bankruptcy law experts also were widely recognized experts in secured transactions law and were involved in the development of UCC Article 9. Legendary figures in the law such as Peter F. Coogan and Grant Gilmore come to mind.
bona fide purchaser test in BC § 544(a)(3) since 1978.\textsuperscript{179} It has remained unchanged, however, both for strong arm and preference transfer purposes, as discussed below.\textsuperscript{180} But the distinction is more apparent than real as a result of differences between real property law and personal property law. Under the real property law of many states the rights of judicial lien creditors are comparatively weak. For example, in these states a judicial lien creditor takes subject to even an unrecorded mortgage. The practical effect of the bona fide purchaser test for real property, then, is similar to the judicial lien creditor test for personal property under which the lien creditor obtains rights superior to an unperfected security interest.\textsuperscript{181}

Preference avoidance law, including late-perfection, also generally is understood to be based in substantial part on concerns about creditor equality. Much of the foregoing reasoning concerning the strong arm power also applies in the preference context. As with the strong arm power, the judicial lien creditor test for determining when a transfer of personal property takes place for preference purposes has worked well. Indeed, a bona fide purchaser test for determining when a transfer of personal property occurs for preference purposes was abandoned more than 50 years ago because it did not work and substantially impeded the development and use of secured credit. In 1950, Congress amended the Bankruptcy Act\textsuperscript{182} so as to override the (in)famous case of Corn Exchange National Bank v. Klauder.\textsuperscript{183} The then effective Bankruptcy Act conferred on the trustee, in exercising its power to avoid preferences, the rights of a hypothetical bona fide purchaser of personal property (assigned accounts receivable, in Klauder). Klauder, in effect, also gave the trustee the rights of a hypothetical purchaser that was the

\textsuperscript{179} Section 70(c) of the former Bankruptcy Act provided for the trustee's strong arm power until it was superseded by BC § 544(a). Former section 70(c) did not contain a bona fide purchaser test for transfers of real property.

\textsuperscript{180} We note that proposed new BC § 544(a)(4) would apply to all property and is not limited to personal property and fixtures. What effect would the expanded strong arm powers, based on hypothetical reliance on hypothetical incorrect information in a public registry, have on transfers of real property such as mortgages and deeds of trust? Might the new powers render these transfers avoidable through the application real property law doctrines? While we have not considered these questions on the merits, certainly they deserve attention from the real property bar.

\textsuperscript{181} A hypothetical bona fide purchaser test also is found in BC § 545(2), dealing with avoidance of statutory liens. Its origin was a concern about hidden priorities and the belief that if a state creates a statutory lien so weak that it succumbs to a bona fide purchaser it was a disguised attempt to fix priorities among creditors. One recommendation of the National Bankruptcy Review Commission was to cut back on the BC § 545(2) bona fide purchaser test as it has been applied against federal tax liens. National Bankruptcy Review Commission Final Report, Bankruptcy: The Next Twenty Years, Recommendation 4.2.11 at 955 (October 20, 1997).

\textsuperscript{182} Pub. L. No. 461, 81st Cong., 2d Sess. (March 18, 1950) (amending former §§ 60 and 70(c) of the Bankruptcy Act).

\textsuperscript{183} 318 U.S. 434 (1943).
first assignee to give notice to the underlying account obligor.\textsuperscript{184} From the 1950 amendment forward, the test for transfers of personal property in the context of preference avoidance has been based on the priority of a hypothetical judicial lien creditor.

As far as we are aware the Act’s proposed changes to the strong arm and preference avoidance powers do not respond to any widespread dissatisfaction with current law on the part of the bankruptcy bar, the financing bar, debtors, creditors, or any other identifiable affected segment. Fewer than five years ago the National Bankruptcy Review Commission issued its massive Final Report, making numerous recommendations for changes to the Bankruptcy Code. But the Report’s recommendations barely mention the trustee’s avoiding powers. Certainly the Commission did not recommend any fundamental changes in the strong arm and preference powers.\textsuperscript{185} Significantly, the recommendations that do relate to avoidance uniformly propose restricting, rather than expanding, the trustee’s avoidance powers.\textsuperscript{186}

The Act’s sponsors have asserted that Section 103 of the Act “restores to trustees in bankruptcy the ability to review and set aside suspect transactions which they enjoyed as lien creditors under Article 9 of the Uniform Commercial Code prior to the UCC amendments that became effective on January 1, 2002.”\textsuperscript{187} That statement is manifestly incorrect.

First, as demonstrated above, the striking impact that the new avoidance powers would have on secured financing goes far beyond overturning the changes made in Revised UCC Article 9. Second, it would “restore” nothing other than arguments about preference

\textsuperscript{184} *Klauder* was decided long before the UCC existed as a uniform law, much less as actual law. At the time states had various conflicting rules on the priority of competing assignments of intangibles.

\textsuperscript{185} Moreover, the Commission must have been aware of the status of the planned revisions to UCC Article 9. By 1997 most of the substantive proposals already were on the table. For example, a provision substantially similar to UCC § 9-338 was included as § 9-335 in the 1997 drafts of the revised Article presented to The American Law Institute and the National Conference of Commissioners on Uniform State Laws.

\textsuperscript{186} See National Bankruptcy Review Commission Final Report, Bankruptcy: The Next Twenty Years, Recommendations 3.2.1 at 797-98 (transfers of less than $5,000 may not be sought in action to avoid nonconsumer debt preference); 3.2.2 at 799-800 (preference recovery action of less than $10,000 must be brought in district in which transferee has principal business); 3.2.3 at 800-03 (strengthening protection from preference avoidance for ordinary course payments); 4.2.11 at 955 (October 20, 1997) (cut back on BC § 545(2) bona fide purchaser test to provide federal tax lien greater protection from avoidance).

\textsuperscript{187} See also Press Release following the August 1, 2002 Durbin and Delahunt Press Conference ("[I]t [the Act] restores to bankruptcy trustees the full authority to challenge and set aside pre-bankruptcy transactions that take assets out of the company.") Of course, in the transactions addressed in this report, assets of an equal or greater value (e.g., loaned funds or purchased property) come in as the debtor's property consisting of new assets, a feature the sponsors have not mentioned.
avoidance powers that were settled more than fifty years ago. Third, Revised UCC Article 9 did not diminish the powers of a trustee. Fourth, the vast majority of the transactions that would be rendered ineffective in bankruptcy by the Act are far from “suspect.” Instead, they are mainstream business and consumer finance transactions on which our economy depends. And these financing transactions are supported by a legal platform, UCC Article 9, that is the most modern and efficient in the world.

Finally, even if modification of the avoidance powers could somehow be limited to the recent changes in UCC Article 9, why would Congress have any interest in dismissing the clearly demonstrated public will? Revised UCC Article 9 emerged from almost a decade of work by The American Law Institute and the National Conference of Commissioners on Uniform State Laws, the co-sponsors of the UCC and two of the most respected law reform institutions in the world. Representatives of virtually every interest affected by secured transactions participated in the drafting process, including the bankruptcy bar and consumer and business debtors. Drafts of the new statute were extensively discussed and debated in panels and meetings sponsored by organizations such as the American Bar Association, the American College of Bankruptcy, The American College of Commercial Finance Lawyers, the American College of Mortgage Attorneys, and the American Bankruptcy Institute. Following its unanimous approval in 1998, it was presented to the legislatures for adoption, a process that normally takes 8 to 10 years. Because of the strong national support, the need for immediate adoption, and the lack of any organized opposition to the changes, Revised UCC Article 9 was adopted by the legislatures in all 50 states and by the District of Columbia by July 1, 2001, and is now effective in all 50 states, the District of Columbia, and the U.S. Virgin Islands. Indeed, Revised UCC Article 9 enjoys the fastest adoption record in the more than 100-year history of the National Conference. Article 9 has been considered the “crown jewel” of the UCC for almost 50 years, being the most bold and innovative of the UCC’s articles. Why would the United States Congress wish to flout this important and successful domain of state law?

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188 Note, for example, that Revised UCC Article 9 received the strong approval of the American College of Bankruptcy.
D. **Effect of Limiting Expanded Avoidance Powers to Cases of Actual Incorrect Information in Public Registry**

The Act’s expanded avoidance powers could be curbed by revising it to address only (i) the rights of a good faith purchaser that relies on incorrect information under UCC § 9-338 and (ii) cases in which the public registry *actually contains* incorrect information in connection with the particular transfer to be avoided. Under this approach, for example, if a financing statement on file actually contained incorrect information that did not render a security interest unperfected under UCC Article 9,\(^{189}\) the trustee would have the rights of a hypothetical purchaser that hypothetically relied on the actually incorrect information.\(^{190}\) So revised, the expanded avoidance powers would reach a narrower slice of transactions. However, even this narrower version would create a material adverse transactional and economic impact, would offend longstanding policies, and would be unnecessary and unwise.

UCC § 9-338 permits a secured party or other purchaser to obtain priority over or cut off a security interest perfected by a filed financing statement if the financing statement contains information specified in UCC § 9-516(b)(5) that is incorrect, but only if the secured party or purchaser reasonably relied on the incorrect information in giving value. The information specified in UCC § 9-516(b)(5) consists of (i) a mailing address for the debtor, (ii) an indication of whether the debtor is an individual or an organization, (iii) if the financing statement indicates that the debtor is an organization, (x) a type of organization for the debtor, (y) a jurisdiction of organization for the debtor; and (z) the debtor’s organizational identification number or an indication that the debtor has none. In evaluating this new filing requirement it is important to understand the structure of the statute. If any of the specified information is missing, the filing office is entitled to reject the filing.\(^{191}\) However, if the filing office nevertheless accepts the filing with the missing information, or if any of the information is incorrect, the filing is effective to perfect a security interest.\(^{192}\) The goal of this

\(^{189}\) A financing statement is effective to perfect a security interest if it contains the names of the debtor and secured party and indicates the collateral that it covers. UCC § 9-502(a). If, for example, the name of the debtor were incorrect and seriously misleading, the financing statement would not be effective and the related unperfected security interest could be avoided under current BC § 544(a)(1). Resort to the Act’s expanded powers would be unnecessary.

\(^{190}\) Of course, not only the proposed expanded strong arm power but also the perfection test for preference avoidance would require adjustment to achieve the intended narrowing effect.

\(^{191}\) UCC § 9-516(b).

\(^{192}\) UCC § 9-502(a).
structure is twofold. First, it encourages the inclusion of possibly useful information in the public record and thereby provides a better quality of public notice. Second, it requires the secured party to provide this information without raising the specter of nonperfection of a security interest if the information provided is inaccurate. UCC § 9-338 strikes the appropriate balance by giving a competing secured party or purchaser a prior claim to collateral only if the secured party or purchaser can show that it was aware of the contents of a financing statement and actually and reasonably relied on the incorrect information.\(^{193}\)

Even a narrowed "actual incorrect information" version of the Act's avoidance powers would substantially increase the trustee's power over that which existed under former UCC Article 9 and the trustee's power that currently exists under Revised UCC Article 9. This is because former Article 9 did not require a financing statement to contain any of the information set forth in UCC§ 9-338, with the single exception of a mailing address for the debtor.\(^{194}\) And under former Article 9 there were precious few reported cases in which financing statements were held ineffective as a result of an inaccurate or incomplete mailing address for the debtor. Some cases even upheld financing statements in the complete absence of a debtor's address where no prejudice could be shown. Under Revised UCC Article 9 (UCC § 9-338) a security interest perfected by a filing containing this type of incorrect information will be cut off or subordinated only in the face of actual reasonable reliance by a competing secured party or other purchaser. But under the Act's hypothetical reliance standard, a trustee in all cases of incorrect information may assume a power rarely available to an actual purchaser outside bankruptcy and may thereby convert a rare event in the real world into an automatic event in bankruptcy.

Because the subordination and cut-off provisions of UCC § 9-338 present a very narrow risk and do not impair the perfection of a security interest, there is every reason to believe that the information prescribed by UCC § 9-516(b)(5) that is found on actual, filed financing statements is much more likely to contain inaccuracies than the more important perfection-related information (name of debtor, name of secured party,

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193 As the official comments to UCC § 9-516 make clear, reliance on the specified information would be quite rare. And it must be shown that the reliance was reasonable. For example, assume a prospective purchaser searches the public record and finds a financing statement filed against the debtor's correct name. The searcher, however, notices that the address given for the debtor is not correct. In order to benefit from UCC § 9-338, the searcher would be required to convince a court that it acted reasonably in purchasing the collateral in reliance on its belief that the financing statement filed against the debtor's correct name was not filed against the debtor, but actually was filed against someone else altogether.

194 Former UCC § 9-402(1).
an identification of collateral\(^{195}\). For this reason, one could expect that even the narrowed version of the Act would render ineffective many security interests in transactions consummated before the Act would take effect.

A likely effect of a narrowed avoidance provision in the Act would be either the repeal of UCC § 9-338 or the elimination of the information specified in UCC § 9-516(b)(5) from Article 9 by state legislatures. This result would recognize that the drafters of Revised UCC Article 9, and the state legislatures that have enacted it, would never have required this additional information to be included in a financing statement if the result of an inaccuracy would be the certain avoidance by the debtor’s trustee in bankruptcy.

Finally, much of the discussion of effects and policy in sections B. and C. above is relevant as well even to a narrowed version of the Act’s avoidance powers.

IV. RECOVERY OF CERTAIN ADMINISTRATIVE EXPENSE CLAIMS FROM PROPERTY SECURING ALLOWED SECURED CLAIMS: SUBORDINATION; “SUPER” PRIORITY ADMINISTRATIVE EXPENSE CLAIMS

A. Description, Application, and Interpretation

Section 203(a) of the Act would add a new paragraph (7) to BC § 503(b). New paragraph (7) would create a new class of administrative expense priority claims for claims arising out of the breach of a fiduciary duty under ERISA or applicable state law relating to a debtor’s pension plan. Under section 203(c) of the Act the new administrative expense claims would receive a “super” priority, superior to other administrative expense priority claims under BC § 507(a)(1). Section 203(b) of the Act also would modify BC § 506 by adding a new subsection (e). That subsection would provide that the holders of unpaid administrative claims of the type specified in proposed BC § 503(b)(7) “may recover any unpaid amount of such claims from any property securing an allowed secured claim.”

Note that subordination under new superpriority would extend beyond traditional secured transactions. An “allowed secured claim” also includes a right of setoff under BC § 506(a). Consequently this section would afford an administrative expense claim priority over a bank’s right of setoff against a deposit account and other rights of setoff.

This report does not address on the merits the proposed creation of

\(^{195}\) UCC § 9-502(a).
a new priority administrative expense claim. It does address, however, the proposed superpriority rule and proposed new BC § 506(e). As an initial proposition, proposed new BC § 506(e) is unclear as to how it would be applied because it does not specify a method for determining which property securing which secured claims would be applied first to satisfy the new administrative priority claims. Would the application be pro rata among all secured claimants and the property securing the claims? Would any such pro rata distribution be based on the value of the collateral involved or (if different) the amount of the secured claim? Would the “unpaid amount” be calculated after or before taking into account distributions to the super-priority claimants from unencumbered assets (presumably after, but the provision does not specify)? Or, would these claimants look first to the property that secures secured claims before looking to unencumbered assets?

Example 4. Debtor owns assets valued at $800,000. One asset has a value of $100,000 and is subject to a security interest held by Lender securing a $10,000 loan. Lender is “oversecured” and its allowed secured claim is $10,000. (For purposes of simplicity, ignore accruing interest, expenses, etc.) There are super-priority pension-related administrative claims under new BC §506(e) in the amount of $800,000. After application of the $700,000 in value of the unencumbered assets, a $100,000 unpaid priority claim remains.

Example 4 presents the simple case involving only one secured claim. Presumably the priority claimants would recover $10,000 in value from Lender’s collateral (the allowed secured claim), reducing Lender’s secured claim to zero. Then the priority claimants would recover the remaining $90,000 in value. The end result is that a fully-secured, indeed over-secured, creditor would recover nothing. Nor would the other remaining unsecured creditors.

In sum: What is clear from the proposed new BC § 506(e) is that one person’s property (a secured claimant’s) would be transferred to another person (the holder of the new super-priority administrative claim), even though the basis of the priority claim (breach of pension-related fiduciary duty) and the secured claim are in no respect related. In that respect, the proposal has the substantive effect of a limited avoidance power from the perspective of the secured claimant, although in form it is structured as a subordination.

As noted above, under a new BC § 507(b)(2), the new pension-related administrative expense claims would receive a “super” priority, superior to other administrative expense priority claims under BC § 507(a)(1). Under this provision, claimants afforded a super priority under current BC § 507(b) (which would be renumbered as BC § 507(b)(1)) would share pro rata with the new BC § 507(b)(2) claimants.
if there were insufficient assets to satisfy all super priority claims.\textsuperscript{196} Claimants under BC § 507(b)(1) (after the proposed renumbering) are those for whom adequate protection of their secured claims failed—it proved to be inadequate protection. Consequently, the new BC § 507(b)(2) claimants could dilute satisfaction of BC § 507(b)(1) (formerly secured) claims in addition to having consumed (under new BC § 506(e)) the collateral that originally secured those claims.

\textbf{B. Transactional and Economic Impact; Rationale}

The rationale indicated by the sponsors for the subordination rule of proposed new BC § 506(e) is that it would “create[] an incentive for financial institutions to protect their collateral by requiring assurances that the company is living up to its fiduciary obligations.”\textsuperscript{197} This explanation is implausible and is not based on an accurate assessment of the role of secured credit in the economy. Apparently the sponsors believe that secured creditors generally are financial institutions. That is widely known to be incorrect. Apparently they believe as well that secured creditors have the ability to effectively monitor performance of a debtor’s fiduciary obligations and compel the debtor’s performance. That is incorrect as well. Indeed, the sponsor’s justification for 506(e)—that it would promote financial institution monitoring of a debtor’s pension-related behavior—is based on fundamental misunderstandings of the theory and practice of secured transactions.

Credit agreements in ongoing relational credits often contain representations and warranties and affirmative and negative covenants, including financial covenants and financial reporting requirements. But these arrangements are, by necessity and by law, largely self-policing on the part of the borrower. In the first place, lenders are not in a position to second guess auditors, auditing committees of boards, or regulators, or to serve as daily monitors and gatekeepers for their borrowers. Moreover, since the lender liability litigation of the 1980s, well advised lenders have taken precautions not to step across the boundaries of corporate governance by interjecting themselves in the management of their borrowers. To be sure, this normally passive role does not protect a lender that discovers or participates in corporate wrongdoing. The BC already contains the means for a court to equitably subordinate a claim, security interest, or other lien in an appropriate case under BC § 510(c). The point here is simply that there is no reason to believe that the draconian penalties in proposed new BC § 506(e) would cause lenders to take on a daily monitoring role that is both impractical and improper.

\textsuperscript{196} BC § 726(b).
\textsuperscript{197} Section-By-Section Summary at 4.
under established legal doctrine. Instead, new BC § 506(e) would likely cause lenders not to extend credit in reliance on collateral or to extend less credit at higher rates of interest. Clearly these effects would not redound to the benefit of the debtor’s employees.

Even if some relational secured creditors were positioned to be effective monitors (and they are not), the sponsors apparently believe that these relationships are a dominant feature in secured transactions. That also is incorrect. Much secured credit, especially that entered into with large, public firms, tends to be more of the “one-shot” or “asset-based” variety. That is to say, a lender places substantial reliance on the collateral value for the very reason that the collateral materially reduces the lender’s need to monitor the debtor’s financial condition. Indeed, that is one factor that has been identified as a justification for the social benefits of secured credit. Moreover, in some markets the relationships among market participants are large in number and high in volume. Consider, for example, the securities markets. Functioning of the largest such market, that for U.S. federal Treasury and agency securities, for example, depends on short-term (often overnight) financing in truly staggering amounts. Participants in these markets cannot be expected to tolerate the possibility that their interests in securities are constantly exposed to a potential subordination. The same can be said of the commodity futures markets in which providing collateral (“margin”) is a daily event.

Assuming that the sponsors’ beliefs about the identity of secured creditors and their abilities to effectively monitor were correct, the sponsors’ stated rationale nonetheless does not support enactment of proposed new BC § 506(e). The provision is essentially unjust because it does not reflect a sound or balanced policy. There is no rational basis for singling out one group of property claimants who must give up their property as a form of bankruptcy tax for the benefit of another unrelated favored class. If the goal is to protect these priority claimants at all cost, why not confiscate a lessor’s residual value for the claimants’ benefit or permit the lessee-debtor to use the leased property rent free for an indefinite period as well? Better yet, why not look to the people who are unquestionably those best situated to prevent a breach of fiduciary duties by providing for confiscation of the property of the debtor’s managers and their families?

Finally, proposed BC § 506(e) in tandem with the super priority under proposed BC § 507(b)(2) could yield exactly the opposite results that the sponsors seek to promote. These provisions give the pension-related claims first call on all of a firm’s assets, save only the possibility of sharing with failed adequate protection claimants discussed above. Such a high level of “insurance” could give rise to a serious “moral hazard” problem for the firm’s managers during the period before
bankruptcy. It is entirely plausible that this “protection” actually could induce managers to play fast and loose with pension assets, or at least reduce substantially the deterrence provided by the nonbankruptcy overlay of legal, accounting, and regulatory constraints.

C. Bankruptcy Policy and History

BC § 506(e) represents a radical departure from and well-accepted bankruptcy policies concerning the interrelationship between secured claims and priority claims.

Priority claims among unsecured creditors have long been a part of bankruptcy law. Inasmuch as they contravene the general principle of creditor equality, the justification for priority claims sometimes has been controversial. But they have proven to be a resilient feature of the bankruptcy law landscape. For this reason, this report takes no position on the new proposed pension-related administrative expense priority claims.

However, priority claims must not be confused with secured claims, in which a secured claimant has a property interest (a security interest created by agreement or another lien) securing an obligation. The relationship between the treatment of priority claims and secured claims generally has not been controversial. Secured claims are satisfied first out of (but only to the extent of) the property securing the claims. Priority claims then are satisfied out of remaining unencumbered assets in their respective order of priority under BC § 507(a). If any assets remain, the non-priority unsecured creditors are next in line. New BC § 506(e) would change all of this solely for the benefit of the new pension-related priority claims. These priority claims would override and subordinate a secured claimant’s property interest. This being the case, it is perhaps not surprising that, as discussed above, it is unclear just how proposed BC § 506(e)’s sui generis conceptual structure would be applied in practice and that its statutory construct seems incomplete.

Not only proposed BC § 506(e) but also the new super priority status under proposed BC § 507(b)(2) conflicts with the BC’s essential structure for dealing with secured and priority claims. The essential point of the existing BC § 506(a) and (b) is to provide for a secured claimant to receive the value of its collateral or, if fully secured, the full amount of its claim. The BC goes to pains to meet this goal, in particular, by entitling a secured claimant to adequate protection of its interest in a variety of circumstances in which its property interest is
being used by the debtor in bankruptcy.198 The idea is straightforward. If the debtor in possession wishes to use the secured claimant’s collateral in the debtor’s attempts to reorganize for the benefit of the unsecured creditors, it must adequately protect the collateral. In effect, if the unsecured creditors wish to roll the dice they should not be entitled to bet the secured claimant’s collateral. If the judge awards adequate protection (say, a lien or periodic payments) that turns out to be inadequate, the system has failed the secured claimant. That is the basis for the remarkable super priority found in current BC § 507(b)—the inadequately protected secured claimants are entitled to look to all of the firm’s unencumbered assets ahead of any other claimant as a form of compensation for the use of the secured claimants’ property interest. But the Act’s proposed super priority would permit the new pension-related administrative priority claimants to share on a pro rata basis with the claims of the inadequately protected former secured claimants (after those pension-related claimants had already received the entire value of all remaining encumbered assets under proposed BC § 506(e)). Whatever the merits of the proposed administrative expense priority for pension-related claimants, proposed BC §§ 506(e) and 507(b)(2) would yield for secured claims an unprecedented and unfair statutory structure indeed.

Finally, we note the position taken by the American Bar Association House of Delegates in August 1991, as proposed by the Section of Business Law:

FURTHER RESOLVED, that the American Bar Association opposes the enactment, in the absence of the most compelling circumstances, of special interest legislation designed to increase the types of claims entitled to priority under the Bankruptcy Code.

Our concerns about sections 203(b) and (c) of the Act are fully consistent with the ABA’s opposition.

V. RECHARACTERIZING SALES AND OTHER TRANSACTIONS

A. Description, Application, and Interpretation

Section 102 of the Act would add a new subsection (e) to BC § 105, which deals with the power of courts exercising bankruptcy jurisdiction. Proposed BC § 105(e) would confer power on a court to “recharacterize as a secured loan, a sale, lease, or transaction if the material characteristics of the sale, lease, or transaction are substantially similar to the characteristics of a secured loan.” The new provision

198 The right to adequate protection derives from the interplay of BC §§ 361-364.
apparently would make the characterization of a putative sale, lease, or any other transaction a matter of federal bankruptcy law as opposed to state property law, which normally governs these questions.

B. Transactional and Economic Impact; Rationale

Most state law on the issue of recharacterizing property transactions is case law that has developed well-understood guidelines that enable counsel to give customary written legal opinions on the characterization of a transaction in a variety of settings. This is true not only for securitization transactions, mentioned below, but for leases and various other transactions in which a property interest is transferred. In stark contrast, the proposed federal test provides no guidelines whatsoever other than a vague “material characteristics”/“substantially similar” test. Indeed, it is quite conceivable that a court could conclude that a putative sale is a secured loan merely because it involves the transfer of funds in exchange for a transfer of a property interest, which are the “material characteristics of a secured loan.”

Each year a huge amount of funding is provided through securitization transactions. These transactions can provide a lower-cost method of providing liquidity to virtually all firms, but the cost savings of securitization transactions are most dramatic for those that cannot issue investment grade securities. For example, by allowing the firm to sell receivables to a special purpose entity that will issue securities backed by the receivables, the firm’s cost of financing can be substantially reduced. But these cost savings can be realized only if the rating agencies are satisfied that there is little or no risk that the receivables would be treated as property of the firm’s estate were the firm subsequently to file a bankruptcy petition. They generally rely on “true sale” legal opinions. By removing the sale characterization from state law and imposing a vague, unpredictable, and open-ended federal “test,” the Act would create an indeterminate range of uncertainty on the true sale question, which would be commercially devastating. This uncertainty also could impose additional risks and costs in “repo” transactions in the securities markets as well as on more traditional non-recourse factoring arrangements.

Note also that proposed BC § 105(e) is agnostic as to whether a putative sale, lease, or other transaction purports to transfer property by or to a debtor. In either case a court could recast the sale as a secured loan. Moreover, the statute does not explicitly confer on a court the power to recast a secured loan as a sale or lease. The proposed revision, then, leaves the characterization of transactions partially to a federal standard and partially to state-law standards. The role of state law is
discussed further below.

C. Bankruptcy Policy and History

The filing of a bankruptcy petition creates an "estate" that in general includes "all legal or equitable interests of the debtor in property as of the commencement of the case."\(^{199}\) What is "property" in this context conceptually is a question for federal bankruptcy law. But as interpreted by the Supreme Court in the \textit{Butner} case, courts must look to nonbankruptcy—normally state—law in order to determine whether and the extent to which property of the debtor exists "unless some federal interest requires a different result."\(^{200}\) As discussed above, Section 102 of the Act would add a new BC § 105(e), which would give a court explicit authority to recharacterize a transaction, such as a sale, as a secured loan if it has the characteristics of a secured loan.

We do not question the proposition that a court should attempt to characterize the economic substance of a transaction in determining its appropriate character for purposes of applying bankruptcy law. This happens regularly under current law by the application of well-established state laws. We do question, however, the wisdom of statutorily federalizing this important issue of property law for purposes of bankruptcy—at least without additional thought and deliberation. We are aware that a very few states have enacted laws that would permit "true sale" treatment for transactions without regard to economic substance and we express no view on the merits of those laws.\(^{201}\) Instead, we suggest that the question of the effectiveness of those laws in bankruptcy be left to the courts in their determination as to whether a conflicting federal interest exists, as \textit{Butner} instructs.\(^{202}\) Thus, to the extent that state law may create or lead to abuses from a bankruptcy perspective, federal law already contains the cure. The proposed statutory fix is totally unnecessary, particularly given the devastating impact that it would have on an industry that supplies much needed capital to business enterprises both here and abroad. State law, when examined in the bankruptcy context, for the most part has proved workable and sensible.\(^{203}\)

\(^{199}\) BC § 541(a)(1).


\(^{201}\) \textit{See}, e.g., 6 Delaware Code §§ 2702A, 2703A.

\(^{202}\) If the statute were merely an effort to codify \textit{Butner}'s "federal interest" test it could do so with much narrower language.

\(^{203}\) While the negative impact on securitization transactions may present the most obvious problem raised by the proposed recharacterization test, it is important to note as well the extreme breadth of the proposal. It encompasses not only sales and leases but virtually any property-related transaction, such as consignments, licenses, and all forms of bailments. It would apply not
VI. RETROACTIVE EFFECTIVENESS

A. Description, Application, and Interpretation

Section 106 of the Act provides that Title I (including the proposed revised avoidance powers and recharacterization provision) is immediately effective upon enactment and applies to bankruptcy cases and proceedings “commenced before, on, or after the date of enactment of this Act.” Avoidance or recharacterization would mean that pre-existing and vested property rights would be upset even in pending cases. Under Section 206 of the Act, Section 203(b) (subordinating secured claims to the new pension-related administrative expense priority claims) would apply only to “liens created on or after the date of enactment of the Act.”

B. Transactional and Economic Impact; Rationale

The immediate and retroactive application of Title I of the Act upon enactment would have a material impact. Because it would apply even in pending bankruptcy cases and proceedings, it would spawn many new avoidance actions under both the strong arm and preference avoidance powers. Perfected security interests previously entitled to adequate protection and secured claims that ultimately would have been satisfied by a distribution or under a reorganization plan would become unsecured. Depending on the stage and posture of a case or proceeding, difficult procedural questions well might arise. For example, what would be the effect of the Act in a pending case in which a plan already had been confirmed based on the pre-Act avoidance regime?

C. Bankruptcy Policy and History

In a report on bankruptcy legislation the Chair of the Section of Business Law of the American Bar Association observed:

Most American laws are designed to operate prospectively. This is

only to personal property but also to real property. We are unaware of any bankruptcy-related problems that would require such broad statutory authority. For example, cases are legion in which bankruptcy courts have applied state law to recharacterize putative leases of goods as secured transactions subject to the perfection and priority rules of UCC Article 9. See UCC § 1-203 (Leases Distinguished From Security Interests) (revised 2001); UCC § 1-201(37) (definition of “security interest,” including guidelines on the lease versus security interest distinction) (as generally enacted).
not the place for an extended exposition on the meaning of Article 1, Section 9, Clause 3 of the United States Constitution, which provides that no "Bill of Attainder or ex post facto Law shall be passed." The sense in that constitutional provision is that it is fundamentally unfair to change rights which existed, and on which citizens relied, prior to the time that Congress or another appropriate body changed the law."

George Clemon Freeman, Jr., Report, at 7 (August 1991). Although Mr. Freeman recognized that federal taxation legislation sometimes operated from the time it was introduced in Congress, he lamented that in the case of bankruptcy legislation "[r]etroactivity had become fashionable." Id. at 10.

Unfortunately, as Mr. Freeman noted, bankruptcy legislation has not always spoken only prospectively. However, the proposed immediate and retroactive effect of the Act generally is much more aggressive than other recent bills. Especially given the striking nature of the modifications of property rights that the Act would impose, the immediate and retroactive application of the proposed avoidance and sale-recharacterization provisions would be both unwise and unfair.

VII. OPEN HEARINGS ON APPROPRIATE NOTICE

We note the position taken by the American Bar Association House of Delegates in August 1991, as proposed by the Section of Business Law:

RESOLVED, that the American Bar Association opposes amendment of the Bankruptcy Code by a legislative process which avoids fair opportunity for open hearings, on well-publicized notice, before the Judiciary Committees of Congress (the Committees in whose jurisdiction bankruptcy legislation is vested).

The flaws in the Act which we have identified in this report illustrate the wisdom of the position taken by the ABA, which we support. In addition, it is essential that well-publicized legislative hearings be held before the Congress or any of its committees takes action on the Act or any of its provisions. In particular, all affected parties and organizations must be given a reasonable opportunity to be heard or represented.

VIII. CONCLUSION

We seriously doubt that responsible legislators such as the Act's sponsors fully appreciate the enormous adverse effects that would result from enactment of the provisions of the Act discussed here. The
sponsors and their staffs may have received some ill-conceived or incomplete advice as to the operation and effects of these provisions. This observation underscores the need for a careful, deliberate, and transparent legislative process. The process should employ open and well-publicized hearings and afford opportunities to testify to a broad spectrum of affected persons and entities.

It is commonly known that there exists considerable political turmoil in the fall of this election year. This largely results from highly publicized recent examples of corporate misbehavior, large corporate bankruptcy filings, and waning public confidence in the economy. Having studied the Act, we have grave concerns about attempts to enact material amendments to the Bankruptcy Code in a rush to react to these events in the present political climate. The provisions of the Act that we have addressed here would have an immediate and severe adverse effect on the national economy. They should not become law.