

**REPORT ON AVOIDANCE, SUBORDINATION, SUPER PRIORITY,  
AND RECHARACTERIZATION PROVISIONS OF THE PROPOSED  
EMPLOYEE ABUSE PREVENTION ACT OF 2002**

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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.”<sup>1</sup> 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 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 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 UCC Article 9.<sup>2</sup> The proposed avoidance powers in the Act go far beyond negating the recent changes made to UCC

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1. See Section-By-Section Summary at 1.

2. See Section-By-Section Summary at 2.

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;
  - 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 existed<sup>3</sup> 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.<sup>4</sup>

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3. 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.

4. 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.

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 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.<sup>5</sup> 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.<sup>6</sup> 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.<sup>7</sup> 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.

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5. UCC § 9-317(a).

6. UCC § 9-320(a).

7. 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.

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.<sup>8</sup>

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.

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8. See, e.g., UCC §§ 9-331 (rights of purchasers of instruments, documents, and securities under UCC Articles 3, 7, and 8); 9-328(1) (control priority).

## 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 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.<sup>9</sup> (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.<sup>10</sup> 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.<sup>11</sup>

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9. BC § 547(e)(1)(B).

10. Alternatively, the security interest would be protected from avoidance under BC § 547(c)(1) (contemporaneous exchange for new value) or (3) (purchase-money security interest).

11. BC § 547(e)(2)(C). The security interest also would not be sheltered from avoidance by BC § 547(c)(1) or (3).

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 security interest by filing a financing statement covering the goods.<sup>12</sup> 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. 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

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12. UCC § 9-320(b).

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 the 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 not 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.<sup>13</sup>

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 bona fide purchaser test in BC § 544(a)(3) since 1978.<sup>14</sup> It has remained unchanged, however, both for strong arm and preference transfer purposes, as discussed below.<sup>15</sup> 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,

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13. 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.

14. 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.

15. 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.

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.<sup>16</sup>

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<sup>17</sup> so as to override the (in)famous case of *Corn Exchange National Bank v. Klauder*.<sup>18</sup> 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.<sup>19</sup> 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

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16. 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).

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

18. 318 U.S. 434 (1943).

19. *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.

recommend any fundamental changes in the strong arm and preference powers.<sup>20</sup> Significantly, the recommendations that do relate to avoidance uniformly propose *restricting*, rather than expanding, the trustee's avoidance powers.<sup>21</sup>

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."<sup>22</sup> 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 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

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20. 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.

21. *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 liens greater protection from avoidance).

22. *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.

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.<sup>23</sup> 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?

**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,<sup>24</sup> the trustee would have the rights of a hypothetical purchaser that hypothetically relied on the actually incorrect information.<sup>25</sup> So revised, the expanded avoidance powers would reach a narrower slice of transactions. However, even this narrower version would create a material adverse

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23. Note, for example, that Revised UCC Article 9 received the strong approval of the American College of Bankruptcy.

24. 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.

25. 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.

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.<sup>26</sup> 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.<sup>27</sup> The goal of this 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.<sup>28</sup>

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

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26. UCC § 9-516(b).

27. UCC § 9-502(a).

28. As the official comments to UCC § 9-516 make clear, reliance on the specified of 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.

the single exception of a mailing address for the debtor.<sup>29</sup> 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, an identification of collateral<sup>30</sup>). 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.

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29. Former UCC § 9-402(1).

30. UCC § 9-502(a).

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 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.<sup>31</sup> 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.

## **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.”<sup>32</sup> 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

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31. BC § 726(b).

32. Section-By-Section Summary at 4.

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 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.<sup>33</sup> 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

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33. The right to adequate protection derives from the interplay of BC §§ 361-364.

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 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.”<sup>34</sup> What is “property” in this context conceptually is a question for federal bankruptcy law. But as interpreted by the Supreme Court in the *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.”<sup>35</sup> 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 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.<sup>36</sup> 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 *Butner* instructs.<sup>37</sup> 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.<sup>38</sup>

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34. BC § 541(a)(1).

35. *Butner v. United States*, 400 U.S. 48, 55 (1979).

36. *See, e.g.*, 6 Delaware Code §§ 2702A, 2703A.

37. If the statute were merely an effort to codify *Butner*'s “federal interest” test it could do so with much narrower language.

38. 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

## **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 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

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transaction, such as consignments, licenses, and all forms of bailments. It would apply not 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).

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.