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Consider Process Before Substance

Commercial Law Consequences of the Bankruptcy System: Urging the Merger of the Article 9 Drafting Committee and the Bankruptcy Commission

by

Steve H. Nickles*

Shelly Rothschild's discussion of the decision of the Supreme Court in *Celotex v. Edwards*¹ perfectly illustrates how individual bankruptcy decisions under federal law can immediately, dramatically affect commercial practice under state law. The reason for the effect is, of course, that bankruptcy is both preemptive and pervasive; and bankruptcy is pervasive mainly because its preemptive effect is relatively favorable, procedurally or substantively, to debtors. So, because financially-troubled debtors are likely to choose bankruptcy for its favors, commercial practice must respond with countermeasures whenever bankruptcy decisions create new risks and impose additional costs on creditors. Because of these forces—preemption and pervasiveness—bankruptcy has profoundly, systematically affected the whole of local commercial law. My job is briefly to describe and explain this larger effect, as I see it.

My view is very simple, not really surprising, and surely shared by some of you. Bankruptcy is driving, pressuring, and narrowing commercial law, especially in terms of the classes, ranges, and number of creditors who share in the distribution of an insolvent debtor's property. Inadvertently, quite ironically, bankruptcy has destroyed the ability of commercial law to provide, either by design or accident, a distributive balance that considers social policy and practical fairness in addition to artificial form and theoretical efficiency.

Bankruptcy is fueled by equity. It breathes equity, as fire breathes air. As the bankruptcy fire has spread, commercial law has responded by taking away the fuel of equity by increasing liens.

*Bess and Walter Williams Distinguished Professor, Wake Forest Law School. Professor Nickles was a member of the Article 9 Study Committee which preceded the Drafting Committee.

¹This Article is the text of prepared remarks delivered at the 69th Annual Meeting of the National Conference of Bankruptcy Judges. The occasion for the remarks was an educational program conducted for the entire Conference, on Tuesday, October 31, 1995, by a panel discussing commercial law and the market consequences of bankruptcy court decisions. One of the panelists, Shelly Rothschild, a partner of Andrews & Kurth in Los Angeles, discussed *Celotex Corp. v. Edwards*, 115 S. Ct. 1493 (1995). Her theme was that *Celotex* can be read broadly to expand bankruptcy court jurisdiction and § 105 power; that this reading will empower bankruptcy courts to enjoin payments under letters of credit; and that such injunctions will adversely affect commercial lending. The author followed Ms. Rothschild on the program. His remarks, which are reprinted here without significant change, consider the broader effect of the entire bankruptcy system on the whole of commercial law. He urges an entirely new way of viewing the process of developing bankruptcy law.

There is a huge irony here. Bankruptcy aims for distributive fairness. Equality is its hallmark. Bankruptcy is equity. Yet, it is bankruptcy that is causing the narrowing distribution among creditors under commercial law. Liens are universally available, but discriminatory. They favor certain classes of creditors and thereby narrow the distribution of a debtor's property. By encouraging liens, bankruptcy worsens this narrowness.

Moreover, and with the greatest irony, this effect on commercial law threatens to destroy bankruptcy because bankruptcy depends on equity, and equity and thus bankruptcy shrinks as liens swell. The certain survival of bankruptcy requires disregarding liens, which would mean the complete destruction of commercial law. This final demolition of commercial law is underway.

I do not mean to suggest only that the tail of bankruptcy is wagging the dog of commercial law. This image is too timid and far outdated. The destruction of commercial law surely began with bankruptcy occasionally shaking local law—sporadically, briefly without threatening fatal harm. The relationship has changed. The parts of the animal are fiercely battling for control, fighting to define identity. Each is trying to undermine the principles and structures that allow the other to dominate. They are engaged in all out *mutual retaliatory deconstruction*. The bankruptcy tail has thrown the commercial law dog and is trying to swallow it whole. The tail has turned into a snake and the struggle has become a fight to the death.

I. COMMERCIAL LAW BITES

The fighting between commercial law and bankruptcy broke out around 1978. It started because bankruptcy suddenly became more favorable—was more favorable to debtors compared to former bankruptcy law and more favorable than state law in some important respects.

Commercial law reacted by increasing liens, making equity increasingly, universally more scarce. Article 9 had made creating consensual liens on personal property much easier compared to pre-Code law. During the 1970's and 1980's, however, the courts widely agreed on the widest, loosest interpretation of the already easy requirements for creating security interests. The requirements for perfecting security interests have always been even easier.

During the last twenty-five years, the states also created more nonconsensual statutory liens.² Some of the new statutory liens are hybrid. They arise apart

²By the end of the farm crisis of the 1980's, the number of agricultural liens alone had grown so large and wide that a special ABA subcommittee (headed by David Lander and Steve Turner) spent several years collecting the liens and hundreds of pages reporting on them; and much more thought was required about the effects of these liens—whether supplemental or displacing—on security interests. See, e.g., Steven C. Turner, Richard L. Barnes, Drew L. Kershen, Martha L. Noble & Brooke Schumm, *Agricultural Liens and the U.C.C.: A Report on Present Status and Proposals for Change*, 44 OKLA. L. REV. 9 (1991). They have become so important that the Article 9 Drafting Committee is considering somehow incorporating them within the structure of Article 9 itself. For a useful "rapid find" collection of agricultural liens, see ELDON RILEY, *GUIDEBOOK TO SECURITY INTERESTS IN PERSONAL PROPERTY* Appendix B (2d ed. 1995).

from Article 9, but are filed and enforced within the framework of Article 9. In function, they are nonconsensual Article 9 security interests. In effect, the states, in creating these liens, have completely done away with the requirements for security interests.

Academics have gone further by arguing for treating initial, primary lenders the same way, giving lenders—by law and without any agreement—a security interest in all of their debtors' property.

Bankruptcy has reacted to the spread of liens by sharpening traditional weapons and by beginning to use the ultimate strategy that will finally, completely, and forever destroy commercial law.

II. BANKRUPTCY STRIKES BACK

Bankruptcy has reacted in traditional terms by interpreting widely—some would say by interpreting creatively, even unlawfully—the provisions of the Bankruptcy Code that can dilute, eliminate, or counter the force of liens. The avoiding powers have widened and so too the automatic stay, which has been pried off its hinges by the bankruptcy courts using the power tool of § 105.³ And, as Shelly Rothschild warns, *Celotex* may widen § 105 itself. Also, trustees, debtors-in-possession, and unsecured creditors have pushed very hard and relentlessly to open up §§ 506(c)⁴ and 510(c).⁵ Success under § 506(c) would effectively raise the bankruptcy tax on secured claims; and success under § 510(c) would effectively lower the priority of secured claims. Either way, the secured creditor's collateral is shared with bankruptcy administration, the debtor and

³See 11 U.S.C. § 105(a) (1994). Section 105(a) provides:

(a) The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title. No provision of this title providing for the raising of an issue by a party in interest shall be construed to preclude the court from, sua sponte, taking any action or making any determination necessary or appropriate to enforce or implement court orders or rules, or to prevent an abuse of process.

Id.

⁴*Id.* § 506(c). Section 506(c) provides:

(c) The trustee may recover from property securing an allowed secured claim the reasonable, necessary costs and expenses of preserving, or disposing of, such property to the extent of any benefit to the holder of such claim.

Id.

⁵*Id.* § 510(c). Section 510(c) provides:

(c) Notwithstanding subsections (a) and (b) of this section, after notice and a hearing, the court may—

(1) under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim or all or part of an allowed interest to all or part of another allowed interest; or

(2) order that any lien securing such a subordinated claim be transferred to the estate.

Id.

unsecured creditors. Another favorite means to the same end is deflated valuations of collateral, although the power of under-valuation has been undermined in some cases by limits on lien stripping.

Interestingly, at the same time that bankruptcy was reacting to the spread of liens, a counteraction to liens also occurred under state law. Debtors and unsecured creditors started making end runs around the conventional law that routinely subordinates them to the claims of secured lenders. Debtors and, equally, subordinate creditors began relying on irrepressible tort law and evolutionary contract law—they invented or popularized the lender liability theory—to trump or undermine the standard paradigmatic rules of secured transactions law. This theory has been relentlessly pursued in bankruptcy mainly by repeated efforts to stretch the traditional bounds of equitable subordination under § 510(c).⁶

III. COMMERCIAL LAW BITES AGAIN

Secured creditors have responded both privately and publicly to judicial interpretation of bankruptcy law that dilutes the value of secured claims. Privately, secured creditors have reactively adjusted the structure of transactions; and, when the transactional slack is finally completely exhausted, secured creditors have used uncertain tactics intended to immunize them altogether from the debtor's bankruptcy. Examples are broader suretyship arrangements and pre-bankruptcy waivers of the automatic stay by the debtor and sureties. Secured creditors have responded publicly to bankruptcy's dilution of liens by persuading Congress to adjust the Bankruptcy Code on an *ad hoc* basis. Indeed, to use Bankruptcy Judge Lisa Fenning's words, "fixing the statute is often seen as the best solution to bankruptcy's 'warping' of commercial law."⁷

Broader, organized, systemic adjustments in state law will surely come. Changes are being considered in Article 9 of the Uniform Commercial Code that will effectively immunize security interests from attack under § 544(a).⁸ Automatic perfection is increased; and, perfecting by filing is made so easy that,

⁶*See id.*

⁷Honorable Lisa Hill Fenning, *Litigation by Other Means: Unconventional Solutions to Recurring Problems*, BANKRUPTCY LITIGATION, April 1994, at 3-6 (Newsletter of the Bankruptcy and Insolvency Committee of the Section of Litigation of the American Bar Association) (discussing several specific skirmishes between commercial law and bankruptcy that were settled by federal or state legislation).

⁸11 U.S.C. § 544(a) (1994). Section 544(a) provides in part:

(a) The trustee shall have, as of the commencement of the case, and without regard to any knowledge of the trustee or of any creditor, the rights and powers of, or may avoid any transfer of property of the debtor or any obligation incurred by the debtor that is voidable by—

(1) a creditor that extends credit to the debtor at the time of the commencement of the case, and that obtains, at such time and with respect to such credit, a judicial lien on all property on which a creditor on a simple contract could have obtained such a judicial lien, whether or not such a creditor exists

Id.

when coupled with electronic recording, the filing process is itself virtually automatic. As a result, the already small pool of fortuitous equity that collects in bankruptcy from failed filings will completely dry up.

Another idea for changing Article 9 will widen the definition of "proceeds." Proceeds will mean anything associated with collateral. The effect is to increase postpetition collateral and dry up another source of equity.⁹

Most importantly, the changes being considered in Article 9 will widen the scope of the statute.¹⁰ Almost every exclusion from the statute will be eliminated. Even deposit accounts and insurance proceeds will be covered as original collateral.¹¹ So the range of reliably lienable property that is safe against bankruptcy will increase, and the amount of equity to power bankruptcy will—once again—correspondingly decrease.

In the end, if the struggle between commercial law and bankruptcy is fought only in traditional terms, commercial law will strangle bankruptcy to death, choking off every breath of equity which is essential to bankruptcy life.

IV. BANKRUPTCY (MAYBE) FINALLY WINS

The fight, however, is not over. Bankruptcy is not done. But, it is against the wall and shows signs of using a strategy that, if allowed, commercial law cannot possibly answer. It is the power to ignore liens altogether in bankruptcy (at least prospectively), which includes the power to define property for purposes of bankruptcy so as to lessen liens (at least consistently with the Fifth Amendment).

Already there are rumors of some developing academic support for the notion that liens are not property. Rather, liens are state-law priorities only or merely remedies with no force in bankruptcy. Even I admit to thinking once that, at its core, property is nothing more than a label that describes a claim having a certain relation to other interests—having a certain priority.

⁹Bankruptcy generally honors security interests in postpetition proceeds.¹¹ U.S.C. § 552(b)(1)(1994). Section 552(b)(1) provides:

(b)(1) Except as provided in sections 363, 506(c), 522, 544, 545, 547, and 548 of this title, if the debtor and an entity entered into a security agreement before the commencement of the case and if the security interest created by such security agreement extends to property of the debtor acquired before the commencement of the case and to proceeds, product, offspring, or profits of such property, then such security interest extends to such proceeds, product, offspring, or profits acquired by the estate after the commencement of the case to the extent provided by such security agreement and by applicable nonbankruptcy law, except to any extent that the court, after notice and a hearing and based on the equities of the case, orders otherwise.

Id.

¹⁰The scope of Article 9 is mainly set by U.C.C. § 9-102, subject to exceptions described by § 9-104.

¹¹Security interests in this property (at least as original collateral) are currently expressly excluded from the scope of Article 9. U.C.C. § 9-104(g), (l).

More surprising is a tiny, hardly recognizable beginning of judicial support for the notion. I refer to recent bankruptcy decisions that refuse to recognize the state law of constructive trusts and the like.¹² One explanation the courts give in these cases is that constructive trusts and the like are not property—not claims or interests traceable to the prepetition circumstances that give rise to them under state law. Rather, constructive trusts and the like, when pursued postpetition, are only remedies without meaning in bankruptcy because they lack any prepetition existence.

Rethinking and redefining liens as something other than property would allow bankruptcy finally to destroy commercial law. How is this final destruction possible inasmuch as state law decides what is property for purposes of bankruptcy law? First, this deference to state law might erode. Second, because of the pervasiveness of bankruptcy and the responsive growth of liens, the view might develop that even under state law, liens are not legitimate property. Rather, liens are property in name only and in true effect are a subterfuge for undermining bankruptcy, which bankruptcy will, accordingly, legitimately ignore.

In the recent case of *XL/DataComp, Inc. v. Wilson (In re Omegas Group, Inc.)*,¹³ the Sixth Circuit reversed the lower courts and denied a creditor's claim of a constructive trust. In response to the argument that state law recognized such a claim, the court conceded that "property rights in bankruptcy are determined only by reference to the state law of the jurisdiction,"¹⁴ but the court added cryptically—that "just because something is so under state law does not necessarily make it so under the Bankruptcy Code,"¹⁵ especially not when the creditor's claim would thwart "the policy of ratable distribution,"¹⁶ "take from the estate, and thus directly from competing creditors,"¹⁷ "lop off a piece of the estate,"¹⁸ and "circumvent completely the Code's equitable system of distribution."¹⁹

We shouldn't be surprised to see this language again. It may be *coming soon* to a law journal near you, or in a judicial opinion or a legislative commentary. I can imagine the very same words or very similar concepts being used to describe the functional, practical effect of a mortgage, security interest, or other lien, and as justification for condemning and ignoring all commercial law liens in bankruptcy.

¹²See, e.g., *Southmark Corp. v. Grosz (In re Southmark Corp.)*, 49 F.3d 1111 (5th Cir. 1995); *XL/DataComp, Inc. v. Wilson (In re Omegas Group, Inc.)*, 16 F.3d 1443 (6th Cir. 1994); *Berger, Shapiro & Davis, P.A. v. Haeling (In re Foos)*, 183 B.R. 149 (Bankr. N.D. Ill. 1995); *Allen-Bradley Co., Inc. v. Commodore Business Machs., Inc. (In re Commodore Business Machs., Inc.)*, 180 B.R. 72 (Bankr. S.D.N.Y. 1995).

¹³16 F.3d 1443 (6th Cir. 1994).

¹⁴*Id.* at 1450.

¹⁵*Id.*

¹⁶*Id.* at 1451.

¹⁷*Id.* at 1452.

¹⁸*Id.* at 1453.

¹⁹*Id.*

So where would this complete destruction of commercial law leave us with regard to the fundamental issue—the fundamental argument—how to distribute a debtor's property? Destroying commercial law by ignoring liens in bankruptcy would take us back to very near the beginning of the issue, forcing us to decide from scratch how to distribute a debtor's property. The issue would be the same, but this time would be fought exclusively within the terms and structure of bankruptcy. Commercial law would become, *de jure*, federal law.

Whether this outcome is good or bad does not depend—or depends only slightly—on concerns about federalism. An overriding national interest in commercial law is recognized in theory and is established in law by the existence of the bankruptcy clause and the supremacy of bankruptcy law, and is proved in practice by the extent to which bankruptcy law has already, directly and indirectly, largely shaped commercial law. Paradoxically, the spread and renewal of uniform state commercial laws recognizes, establishes, and proves that a national law is useful in substance, but the uniform laws commissioners would argue strongly that the critical difference is in the process.

V. CHOOSING THE ARENA

Here, I think, is the bottom-line, the truly central issue.

Whether federalizing commercial law is good or bad depends, ultimately, on whether the federal legislative process is “better” than the uniform laws process. The importance of the process in making commercial law is the theme of recent work by scholars such as Kathleen Patchel,²⁰ Ed Rubin,²¹ and Bob Scott.²² They are somewhat critical of the uniform laws process, in part because of its democratic, political narrowness. The importance of political process has been admitted by the principals constructing a new Article 9—Bill Burke, Steve Harris, Fred Miller, and Chuck Mooney. They have made unprecedented efforts to open up the deliberations of the Study and Drafting Committees.

Even larger political legitimacy could be achieved if the Article 9 Committee joined forces with the Bankruptcy Review Commission and thereby shared the derivative shelter of national political diversity flowing from the Congress and the White House. It would require more than some informal cross-mingling among each group's advisors. It would require a practical merger of the Article 9 Committee and the Commission that links their agendas as tightly as the knot that entwines commercial law and bankruptcy.

²⁰See Kathleen Patchel, *Interest Group Politics, Federalism and the Uniform Laws Process: Some Lessons from the Uniform Commercial Code*, 78 MINN. L. REV. 83 (1993).

²¹See Edward L. Rubin, *Thinking Like a Lawyer, Acting Like a Lobbyist: Some Notes on the Process of Revising UCC Articles 3 and 4*, 26 LOY. L.A. REV. 743 (1993). See also Edward L. Rubin, *Learning from Lord Mansfield: Toward a Transferability Law for Modern Commercial Practice*, 31 IDAHO L. REV. 775 (1995).

²²See Robert E. Scott, *The Politics of Article 9*, 80 VA. L. REV. 1783 (1994). See also Alan Schwartz & Robert E. Scott, *The Political Economy of Private Legislatures*, 143 U. PA. L. REV. 595 (1995).

The Bankruptcy Review Commission would gain a different kind of legitimacy. The Commission is an impressive group of people, but neither they nor any staff they create can match the breadth and depth of expertise and experience that the uniform laws commissioners and structure of NCCUSL (the National Conference of Commissioners on Uniform State Laws) bring to the drafting table. The gains would be even greater if the merger of efforts also included the ALI Restatement Project covering the law of real estate finance. A combination of these efforts—the results of which would be ratified by Congress in enacting a new bankruptcy law and by the states in adopting a new Article 9—would be the best possible process. It would therefore produce the best possible law in terms of political legitimacy and statutory form.

The fight between commercial law and bankruptcy would finally be settled—without any death—or settled for a longer time than we can expect from separate efforts that, in terms of politics and design, can only be second best.

I encourage you to write your favorite bankruptcy Commissioner and also your state's uniform laws commissioners and—here's my conclusion in a slogan—*urge a merger*. You and the whole country deserve nothing second best, only the very best.