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Tracing Proceeds to Attorneys’ Pockets (and
the Dilemma of Paying for Bankruptcy)

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Bankruptcy for companies brings opportunity for attorneys.¹ The attorneys' fees generated in corporate bankruptcies are staggering.² In large, complicated corporate bankruptcies, such as those involving Eastern Airlines, Pan American Airlines, and LTV Corporation, for example, the

1. "[T]he recent tidal wave of bankruptcy work not only has strengthened the quality of bankruptcy lawyers in Houston, but it also has stimulated dramatic growth in the bankruptcy bar." Gary Taylor, *Bankruptcy Work Means Black Gold for Houston Bar*, LEGAL TIMES, Aug. 1, 1983, at 1. The tidal wave has continued to grow in recent years, providing an increasing number of opportunities for lawyers. "Of the 30 largest bankruptcies in US history, 25 have occurred since the beginning of 1988." Aaron Pressman, *Can Chapter 11 Be Put Back Together?*, INVESTMENT DEALERS' DIGEST, Apr. 27, 1992, at 17. "In 1990 the assets of public corporations filing for bankruptcy totaled \$82.7 billion—50 times more than a decade earlier." Stratford Sherman, *Bankruptcy's Spreading Blight*, FORTUNE, June 3, 1991, at 123. "Eleven companies with assets of \$1 billion or more declared bankruptcy in 1991." Mary Graham, *Bankrupt and Bullish*, THE ATLANTIC, Mar. 1992, at 24. "Last year, more than . . . 70,000 businesses filed for protection under U.S. bankruptcy laws." Robert Lawless, *The Hidden Costs of Bankruptcy Reform*, THE CHRISTIAN SCI. MONITOR, July 2, 1993, at 19.

2. Several recent bankruptcies illustrate the vast magnitude of these attorneys' fees and expenses. The Johns-Mansville Corp., for example, expended \$74.3 million in total attorneys' fees during its prolonged reorganization proceedings. Eva Rodriguez, *Eastern Lands in Friendlier Legal Terrain*, LEGAL TIMES, Mar. 27, 1989, at 10. Law firms, including Davis Polk & Wardwell which received \$41 million in fees on the LTV Corp. bankruptcy, have profited from large corporate bankruptcies. *Fees from LTV's Bankruptcy Exceed \$200 Million*, N.Y. TIMES, Aug. 25, 1993, at D3. In another well-publicized bankruptcy, Drexel Burnham Lambert Group produced over \$35 million in fees for Weil, Gotshal & Manges. Stella Dawson, *U.S. Cracks Down on High Fees in Bankruptcy Cases*, REUTER RUS. REP., June 5, 1992, available in LEXIS, Nexis Library, BUSRPT File. Weil, Gotshal & Manges also received \$4.86 million from Eastern Airlines, and \$2.46 million in fees from Texaco in their respective bankruptcies. Linda Himelstein, *Crackdown Looms on Bankruptcy Lawyers' Bills*, LEGAL TIMES, June 22, 1992, at 24. Rubenstein & Perry and Morgan, Lewis & Bockius both struck gold, receiving \$5 million each in the Executive Life Insurance bankruptcy. Cynthia Crosson, *Exec Life Conservation Fees at \$30 Million and Climbing*, NATIONAL UNDERWRITER CO. LIFE & HEALTH/FIN. SERVICES EDITION, Mar. 30, 1992, at 1, available in LEXIS, Nexis Library, NULIFE File. Finally, Keck Mahin & Cate and Katten Muchin & Zavis together earned an award of \$1.4 million working on the Schwinn Bicycle Chapter 11 reorganization. *Payday for Schwinn Lawyers, Consultants*, CRAIN'S CHICAGO BUS. J., June 28, 1993, at 38, available in LEXIS, Nexis Library, CHIBUS file.

combined costs of professional services, including attorneys' fees, have totaled well over \$250 million.³ In smaller business bankruptcies, attorneys' fees typically amount to at least \$50,000 and often exceed \$200,000.⁴

These lucrative fees have not gone unnoticed. Both the popular press⁵ and Congress⁶ have recognized and criticized

3. "A total of almost \$270 million in bankruptcy fees have already been paid out just in Eastern Airlines, Pan Am, and LTV." *News Conference with the U.S. Dept. of Labor*, Federated News Serv., June 5, 1992 (quoting Sec. of Labor Lynn Martin), available in LEXIS, Nexis Library, FEDNEW file. Aggregate professional fees of \$100 million or more are not uncommon in large Chapter 11 cases. For example, Federated Department Stores, Inc. incurred total professional fees of \$121.2 million during its bankruptcy. Jack Neff, *121 Million Ok'd for Professionals in Bankruptcy Case of Rich's Parent*, ATLANTA CONST., July 1, 1992, at E7. Johns-Manville's bankruptcy fees also reached the \$100 million mark. Sherman, *supra* note 1, at 123. Also notable, Continental Airlines amassed \$60 million in its 1982 bankruptcy, Graham *supra* note 1, at 26, and Ames Department Stores expended over \$65 million in a similar proceeding, Phyllis Furman & Peter Grand, *A Bankrupt Court*, CRAIN'S N.Y. BUS., Apr. 5, 1993, at 1, available in LEXIS, Nexis Library, NYBUS file.

More striking are the sizable fees incurred during a single bankruptcy over a relatively brief period of time. For example, the bankruptcy court awarded \$109 million in the Drexel Burnham Lambert Group case for professional fees incurred from February 1989 to November 1991. Claudia MacLachlan, *Anger Rises over Bankruptcy Fees*, NAT'L L.J., Mar. 9, 1992, at 33. Bankruptcy courts also awarded \$95 million in fees for the period from March 1989 to February 1992 in the Eastern Airlines bankruptcy, and \$90 million for the period from June 1988 to February 1992 in the Revco D.S. Inc. bankruptcy. *Id.*

4. *Why You Should Avoid a Chapter 11 Filing*, DM News 51 (Sept. 28, 1992) available in LEXIS, Nexis Library, DMNEWS file. "Reorganization 'can be too expensive for small businesses,' says Harry Dixon, the chairman of the American Bankruptcy Institute. . . . Lawyers and accountants charge \$100 to \$500 an hour and like to be paid right away. Often they require a retainer in advance. Even a fairly simple case can cost \$100,000." Graham, *supra* note 1, at 37. "Chapter 11 is too tedious and expensive an experience for small firms to absorb. Most firms in Chapter 11 slip-slide into liquidation after months and sometimes years of desperately trying to 'reorganize.'" Sindhu Sethuram, *Bankruptcy Reform May Benefit Small Businesses*, S. FLA. BUS. J., Mar. 12, 1993, § 1, at 4A. For an amusing story about the payment of fees, see John Taylor, *Will Work For Food*, FORBES, Oct. 12, 1992, at 20 (noting celebrity chef Wolfgang Puck's agreement to cover chapter 11 legal expenses for a brewery in which he holds an interest by providing his bankruptcy counsel with up to \$25,000 in meals at his restaurants).

5. See, e.g., Graham, *supra* note 1, at 24 ("When Eastern declared bankruptcy to reorganize, in 1989, it had a net worth of more than \$1 billion. . . . Twenty-two months later virtually all of the money that would have gone to unsecured creditors had been used up in a futile attempt to keep the planes flying, in fees for lawyers, accountants, and investment bankers, and in other expenses."); John Greenwald, *The Bankruptcy Game*, TIME, May 18, 1992, at 61 ("LTV . . . has forked out more than \$100 million in legal fees since it entered Chapter 11 in 1986 yet remains mired in debt."); Pater Passel, *Critics of Bankruptcy Law See Inefficiency and Waste*, N.Y. TIMES, Apr. 12, 1993, at D10

these fees. More importantly, attorneys' fees have had a direct impact on corporate debtor behavior. Anticipating these fees, corporate debtors often dispose of collateral that is subject to a Uniform Commercial Code ("U.C.C.") Article 9⁷ security interest,⁸ and use the proceeds of such disposition both to pay prepetition attorneys' fees and create retainers for postpetition fees.⁹ Because a secured party¹⁰ has a security interest in the proceeds¹¹ of secured collateral,¹² the use of such proceeds raises a fundamental issue: whether a secured party may recover its interest in proceeds used to pay attorneys' fees. The answer to this question is critical. Failure to protect a secured party's interest contravenes principles fundamental to the U.C.C. Depriving debtors of a means to pay attorneys' fees, however, denies them legal representation and, hence, the venue bankruptcy offers. In short, it undermines one of bankruptcy law's most basic tenets, which is to provide a troubled debtor with legal relief.

("[T]he public is repelled by hefty legal fees that ultimately come out of the pockets of creditors."); Sherman, *supra* note 1, at 123 ("The bankruptcies of Federated and Allied department stores, for example, involve seven committees, each with its own team of lawyers and investment bankers, and the fees already exceed \$19 million. On top of that, the advisers to Federated and Allied themselves have billed the companies over \$31 million.").

6. See Senate Panel Explores Problem of Excessive Fees in Bankruptcy Cases, Daily Rep. for Executives (BNA) No. 58, at A-11 (Mar. 25, 1992) at A-11 (quoting Senator Metzenbaum's observation that bankruptcy creates a "feeding trough" for attorneys and other professionals, and Senator Grassley's proposal that a "blue ribbon commission" study the issue of professional compensation); see also, Sethuram, *supra* note 4, at 4A ("The whole thrust of the proposal is to get the bankruptcy code to do what it is supposed to do—to help small firms in bankruptcy get back on their feet as soon as possible [thus avoiding large costs]").

7. U.C.C. art. 9 (1990 Official Text with Comments).

8. "Security interest' means an interest in personal property or fixtures which secures payment or performance of an obligation." U.C.C. § 1-201(37).

9. Commentators have considered a myriad of issues regarding bankruptcy retainer agreements. See, e.g., Lester Brickman & Jonathan Klein, *The Use of Advance Fee Attorney Retainer Agreements in Bankruptcy: Another Special Law for Lawyers?*, 43 S.C. L. REV. 1037 (1992). Regina S. Kelbon et al., *Conflicts, the Appointment of "Professionals," and Fiduciary Duties of Major Parties in Chapter 11*, 8 BANKR. DEV. J. 349 (1991); Karen J. Brothers, Comment, *Disagreement Among the Districts: Why Section 327(a) of the Bankruptcy Code Needs Help*, 138 U. PA. L. REV. 1733 (1990).

10. "Secured party' means a lender, seller or other person in whose favor there is a security interest. . . ." U.C.C. § 9-105(1)(m).

11. "Proceeds' includes whatever is received upon the sale, exchange, collection or other disposition of collateral or proceeds." U.C.C. § 9-306(1).

12. "[A] security interest continues . . . in any identifiable proceeds including collections received by the debtor." U.C.C. § 9-306(2).

To begin exploration of this issue, Part I of this Article considers the mechanics of awarding attorneys' fees in bankruptcy. Specifically, Part I surveys three separate components of attorneys' fees in bankruptcy: disclosure; application for and approval of employment; and compensation. The Article pays particular attention to the operation of "classic" and special retainer agreements under the Bankruptcy Code.

Part II reviews a secured party's possible challenges to the payment of attorneys' fees in bankruptcy. As Part II details, a secured party can challenge such payments directly and indirectly. In making a direct challenge to payment, the secured party claims that the fee recipient who is paid with the proceeds of secured collateral has converted the secured party's collateral.¹³ Pursuant to an indirect challenge, the secured party argues that payment to a recipient constitutes a preference under section 547(b)¹⁴ or a fraudulent transfer under section 548¹⁵ of the Bankruptcy Code of 1978¹⁶ and thus may be recovered under section 550(a).¹⁷

In Part III, this Article discusses defenses to both types of challenges. In particular, Part III explores an attorney's defenses of authorization¹⁸ and priority¹⁹ in the context of direct challenges. In doing so, this Article notes two anomalous cases: the case in which payments are made for an executory promise to perform future services, and the case in which a bank exercises its right to set-off. Part III concludes by analyzing an attorney's defenses to an indirect challenge: that payment to the attorney falls within a section 547(c)²⁰ exception to section 547(b) or does not meet the requirements of section 548.²¹

Irrespective of the challenges to the payment of attorneys'

13. See *infra*, section II.A.

14. 11 U.S.C. § 547(b) (1988) (stating elements of a preference).

15. 11 U.S.C. § 548 (1988 and Supp. II 1990) (stating elements of fraudulent transfer).

16. Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 (codified as amended in 11 U.S.C.) [hereinafter, the "Bankruptcy Code"]. The Bankruptcy Code replaced the Bankruptcy Act of 1898. Ch. 541, 30 Stat. 544 (codified at 11 U.S.C. § 30 (1898)) (repealed 1978) [hereinafter the "Bankruptcy Act"].

17. 11 U.S.C. § 550(a) (1988) (detailing liability of transferee of a voided preference).

18. A security interest does not continue in proceeds if disposition is authorized by the secured party. U.C.C. § 9-306(2).

19. A security interest in proceeds is cut off where payment is made from those proceeds to a party in the ordinary course. U.C.C. § 9-306 cmt. 2(c).

20. 11 U.S.C. § 547(c) (1988).

21. 11 U.S.C. § 548 states:

Fraudulent transfers and obligations

(a) The trustee may avoid any transfer of an interest of the debtor in property, or any obligation incurred by the debtor, that was made or incurred on or within one year before the date of the filing of the petition, if the debtor voluntarily or involuntarily—

(1) made such transfer or incurred such obligation with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made or such obligation was incurred, indebted; or

(2)(A) received less than a reasonably equivalent value in exchange for such transfer or obligation; and

(B)(i) was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation;

(ii) was engaged in business or a transaction, or was about to engage in business or a transaction, for which any property remaining with the debtor was an unreasonably small capital; or

(iii) intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured.

(b) The trustee of a partnership debtor may avoid any transfer of an interest of the debtor in property, or any obligation incurred by the debtor, that was made or incurred on or within one year before the date of the filing of the petition, to a general partner in the debtor, if the debtor was insolvent on the date such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation.

(c) Except to the extent that a transfer or obligation voidable under this section is voidable under section 544, 545, or 547 of this title, a transferee or obligee of such a transfer or obligation that takes for value and in good faith has a lien on or may retain any interest transferred or may enforce any obligation incurred, as the case may be, to the extent that such transferee or obligee gave value to the debtor in exchange for such transfer or obligation.

(d)(1) For the purposes of this section, a transfer is made when such transfer is so perfected that a bona fide purchaser from the debtor against whom applicable law permits such transfer to be perfected cannot acquire an interest in the property transferred that is superior to the interest in such property of the transferee, but if such transfer is not so perfected before the commencement of the case, such transfer is made immediately before the date of the filing of the petition.

(2) In this section—

(A) "value" means property, or satisfaction or securing of a present or antecedent debt of the debtor, but does not include an unperformed promise to furnish support to the debtor or to a relative of the debtor;

(B) a commodity broker, forward contract merchant, stockbroker, financial institution, or securities clearing agency that receives a margin payment, as defined in section 101(34), 741(5) or 761(15) of this title, or settlement payment, as defined in section 101(35) or 741(8) of this title, takes for value to the extent of such payment;

(C) a repo participant that receives a margin payment, as defined in section 741(5) or 761(15) of this title, or settlement payment, as defined in section 741(8) of this title, in connection with a repurchase agreement, takes for value to the extent of such payment; and (D) a swap participant that receives a transfer in

fees a secured creditor can offer, Part IV contends that paying attorneys' fees in bankruptcy from the proceeds of secured collateral is consistent with the language, legislative history, and purposes of the Bankruptcy Code, and is supported by game theory analysis. In developing this contention, Part IV first explores the manner in which the former Bankruptcy Act assessed bankruptcy costs to secured creditors. It then details the current method for charging costs and expenses to secured parties under section 506(c) of the Bankruptcy Code.²² Utilizing section 506(c), this Article asserts that a trustee²³ may recover from a secured party's interest in secured collateral the reasonable costs of preserving that collateral, including attorneys' fees. As Part IV posits, such fees may be recovered under section 506(c) because of the overall benefits a bankruptcy

connection with a swap agreement takes for value to the extent of such transfer.

11 U.S.C. § 548 (1988).

22. Section 506(c) provides that a trustee "may recover from property securing a . . . 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." 11 U.S.C. § 506(c) (1988).

23. Trustee as used throughout this Article also refers to a Chapter 11 debtor-in-possession. Both terms refer to an individual charged with overseeing the administration of the bankruptcy estate. See 11 U.S.C. § 1107(a) (1988) ("[A] debtor in possession shall have all the rights . . . of a trustee serving in a case."). Because § 506(c) by its terms provides only that a trustee may recover fees, see *supra* note 22 (providing language of § 506(c)), there has been a question about who may bring a § 506(c) action. Some courts have held that only the trustee has standing under § 506(c), thereby precluding any direct action by an attorney. See, e.g., *Boyd v. Dock's Corner Assoc. (In re Great Northern Forest Products)*, 135 B.R. 46, 65 (Bankr. W.D. Mich. 1991); *White Front Feed & Seed, Inc. v. State Nat'l Bank of Platteville (In re Ramaker)*, 117 B.R. 959, 966 (Bankr. N.D. Iowa 1990); *In re J.R. Research, Inc.*, 65 B.R. 747, 749 (Bankr. D. Utah 1986); *In re Proto-Specialties, Inc.*, 43 B.R. 81, 83 (Bankr. D. Ariz. 1984); *In re Manchester Hides, Inc.*, 32 B.R. 629, 632-33 (Bankr. N.D. Iowa 1983); *In re Codesco*, 18 B.R. 225, 230 (Bankr. S.D.N.Y. 1982). The majority of courts, however, have allowed a creditor other than the trustee to bring a direct action, recognizing that denying standing simply increases transaction costs by forcing the creditor seeking recovery under § 506(c) to arrange for the trustee to bring the exact same action on the creditor's behalf. See, e.g., *In re Parque Forestal, Inc.*, 949 F.2d 504, 511 (1st Cir. 1991); *New Orleans Pub. Serv., Inc. v. First Fed. Sav. & Loan Ass'n (In re Delta Towers, Ltd.)*, 924 F.2d 74, 76-77 (5th Cir. 1991); *Equitable Gas Co. v. Equibank, N.A. (In re McKeesport Steel Castings Co.)*, 799 F.2d 91, 93-94 (3d Cir. 1986); *McAlpine v. Comerica Bank-Detroit (In re Brown Bros.)*, 136 B.R. 470, 474 (W.D. Mich. 1991); *In re Saybrook Manufacturing Co.*, 130 B.R. 1013, 1016 (Bankr. M.D. Ga. 1991); *In re Scopetta-Senra Partnership III*, 129 B.R. 700, 701 (Bankr. S.D. Fla. 1991). This Article endorses the majority view. The Article's recurrent references to "trustee" therefore also apply generally to any § 506(c) claimant.

proceeding affords vis-a-vis other creditors' remedies. Lastly, Part IV advances a theoretical argument for permitting the payment of attorneys' fees in bankruptcy. Specifically, through the use of game theory modelling, this Article demonstrates that financing attorneys fees through the use of secured collateral coheres with notions of economic efficiency.²⁴ As this Article illustrates, the benefits bankruptcy offers both the secured party and the debtor vis-a-vis alternative creditors' remedies suggests that, acting rationally, both parties should prefer bankruptcy and that the secured party should therefore accept the costs of such a proceeding.

I. ATTORNEYS' FEES IN BANKRUPTCY

A. THE MECHANICS OF ATTORNEYS' FEE PAYMENTS

The payment of attorneys' fees in bankruptcy involves three separate components: disclosure, application for and approval of employment, and compensation.²⁵ After filing the bankruptcy petition, the debtor's attorney²⁶ must file a statement with the court pursuant to Bankruptcy Code section 329(a) disclosing all compensation "paid or agreed to be paid."²⁷ Bankruptcy Rule 2016(b) implements section 329(a)'s disclosure requirements by requiring the debtor's attorney to file a disclosure document within fifteen days after the order for relief, and by requiring subsequent disclosure documents within fifteen days of any modifications to the agreement or payments.²⁸ This same Bankruptcy Rule also compels an attorney to disclose any fee sharing arrangement as well as the amounts involved.²⁹ If the court

24. Professors Baird and Jackson are the primary proponents of an economic approach to bankruptcy law. They contend that bankruptcy law's primary purposes are both to regulate the process by which individual actors make exchanges against the debtor's pool of assets in their efforts to increase individual wealth, THOMAS H. JACKSON, *THE LOGIC AND LIMITS OF BANKRUPTCY LAW* 10-19 (1986), and to maximize the outcome for creditors by maximizing the value of the pool against which each creditor exchanges its rights. Douglas G. Baird & Thomas H. Jackson, *Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy*, 51 U. CHI. L. REV. 97, 110 (1984); Thomas H. Jackson, *Avoiding Powers in Bankruptcy*, 36 STAN. L. REV. 725, 728 (1984).

25. See Brickman & Klein, *supra* note 9, at 1061-66.

26. The Bankruptcy Code defines "attorney" as an "attorney, professional law association, corporation, or partnership, authorized under applicable law to practice law." 11 U.S.C. § 101(3) (1988).

27. 11 U.S.C. § 329(a) (1988).

28. BANKR. R. 2016(b).

29. *Id.* A "fee-sharing arrangement" is an agreement to divide compensation received in a bankruptcy case between professionals. See *In re Matis*, 73

finds the proposed compensation excessive, it can order the fee agreement canceled and any consideration returned to the payor.³⁰

Section 329 and its accompanying rule emerged from Congress's recognition of the problems inherent in allowing fiduciaries to set their fees without court supervision:

This section, derived in large part from [former] Bankruptcy Act section 60d, requires the debtor's attorney to file with the court a statement of the compensation paid or agreed to be paid to the attorney for services in contemplation of and in connection with the case, and the source of the compensation. Payments to a debtor's attorney provide serious potential for evasion of creditor protection provisions of the bankruptcy laws, and serious potential for overreaching by the debtor's attorney, and should be subject to careful scrutiny.³¹

These disclosure requirements serve to minimize "the temptation of a failing debtor to deal too liberally with his property in employing counsel to protect him in view of financial reverses and probable failure."³²

Section 327, in turn, initially authorizes the trustee or debtor in possession to hire an attorney for the bankruptcy estate with the court's approval.³³ This section provides the court

B.R. 228 (Bankr. N.D.N.Y. 1987) (discussing limits on fee-sharing); *see also* 11 U.S.C. § 504 (1988) (listing prohibitions on fee sharing agreements).

30. 11 U.S.C. § 329(b) (1988); *see* Brickman & Klein, *supra* note 9 at 1061-66.

31. H.R. Rep. No. 595, 95th Cong., 1st Sess. 329 (1977); S. Rep. No. 989, 95th Cong., 2d Sess. 39 (1978), *reprinted in*, 1978 U.S.C.A.N. 5758, 5825.

32. *In re Wood & Henderson*, 210 U.S. 246, 253 (1908); *see also Pfeiffer v. Couch (In re Xebec)*, 147 B.R. 518, 523 (Bankr. 9th Cir. 1992) (quoting *In re Ginji Corp.*, 117 B.R. 983, 992 (Bankr. D. Nev. 1990) ("[T]he Court believes that the correct approach is to scrupulously inquire into such services so as to ascertain whether or not they were for the benefit of the estate or for some other interest."); *In re Marker*, 100 B.R. 569, 571 (Bankr. N.D. Ala. 1989) ("Involuntary clients, the creditors of the estate, may not be forced to accept and pay for something not requested and which is uncertain as to any beneficial effect upon the creditors' interests."); *In re Underground Utilities Const. Co.*, 13 B.R. 735, 736 (Bankr. S.D. Fla. 1981) ("The desperate owner of the debtor is in no position to object [to fees]. He has no time to shop around and if he questions the quoted fee, he may wind up with no attorney."); *In re Steeves*, 3 B.R. 334, 335 (Bankr. D. R.I. 1980) ("The authority of the Bankruptcy Court to review compensation is a traditional power of the court and is essential to prevent overreaching by the debtor's attorneys and to protect creditors.").

33. 11 U.S.C. § 327(a) (1988); BANKR. R. 2014(a). The failure of an attorney to obtain court approval may result in a denial of fees and expenses. *See, e.g., In re Hargis*, 148 B.R. 19, 21 (Bankr. N.D. Texas 1991); *In re Prime Foods of St. Croix, Inc.*, 80 B.R. 758, 760 (Bankr. D.V.I. 1987); *Eastern Inns of N.H. Inc., v. Indian Head Bank & Trust, Inc. (In re Eastern Inns of N.H., Inc.)*, 72 B.R. 418, 420 (Bankr. D. Me. 1987); *In re Yeisley*, 64 B.R. 360, 362 (Bankr. S.D. Tex. 1986); *In re Maller Restaurant Corp.*, 57 B.R. 72, 74 (Bankr. E.D.N.Y. 1985).

with a means of administrative control.³⁴ Under the Bankruptcy Code, the attorney hired must not "hold or represent an interest adverse to the estate"³⁵ and must be a "disinterested person."³⁶ If the court determines that the attorney is not a disinterested person, it may deny the attorney compensation³⁷ and may also deny the trustee compensation for its failure to make a "diligent inquiry" into the facts surrounding the attorney's apparent conflict of interest.³⁸

In applying for a court order approving the employment of counsel, Bankruptcy Rule 2014 requires that the application contain the following elements: 1) the facts showing the necessity of employment; 2) the attorney's name; 3) the reasons for selecting the attorney; 4) the services the attorney will render; 5) the proposed compensation; 6) any relationships the attorney has with any parties in interest; and 7) a verified statement from the attorney disclosing the attorney's relationships with any party in interest or that party's professional employees.³⁹ After the trustee has submitted the application, the bankruptcy judge has sole discretion to decide whether to approve the attorney's employment, and can set any reasonable terms of employment she sees fit.⁴⁰ If the terms of employment eventually prove imprudent, the court can revise them.⁴¹

At the conclusion of the case, or on an interim basis, the court will award attorney compensation.⁴² One can understand attorney compensation in bankruptcy as a struggle between two competing interests, the interest in conserving the bankruptcy estate to increase the common pool available to creditors and equityholders, against the interest in compensating those who administer and provide services to the estate.⁴³ Under the

34. *In re McDaniels*, 86 B.R. 128, 132 (Bankr. S.D. Ohio 1988); *In re Taylor*, 66 B.R. 390, 392 (Bankr. W.D. Pa. 1986); *In re Williamette Timber Sys.*, 54 B.R. 485 (Bankr. D. Or. 1985).

35. 11 U.S.C. § 327(a) (1988).

36. *Id.*

37. 11 U.S.C. § 328(c) (1988).

38. 11 U.S.C. § 326(d) (1988); see *Brickman & Klein*, *supra* note 9 at 1062-63.

39. BANKR. R. 2014.

40. 11 U.S.C. § 328(a) (1988).

41. *Id.*

42. See 11 U.S.C. §§ 330(a), 331 (1988).

43. *Brickman & Klein*, *supra* note 9 at 1052; see e.g., *Moshein v. Beverly Crest Convalescent Hosp., Inc.* (*In re Beverly Crest Convalescent Hosp., Inc.*), 548 F.2d 817, 820 (9th Cir. 1976); *Irving-Austin Bldg. Corp. v. Cunningham* (*In re Irving Ausin Bldg. Corp.*), 100 F.2d 574, 579 (7th Cir. 1938); *In re Ferkauf, Inc.*, 42 B.R. 852, 854 (Bankr. S.D.N.Y. 1984), *aff'd* 56 B.R. 774 (S.D.N.Y. 1985);

Bankruptcy Act of 1898, protection of creditors and equityholders predominated.⁴⁴ Courts took care to prevent overcompensation. Concomitant with public concerns regarding excessive attorney compensation in bankruptcy, many courts specifically asserted that the "public interest . . . must be considered in awarding fees."⁴⁵ In similar vein, one court noted: "In reality, receivers and attorneys are officers of the court. As public servants, their compensation should never be as large as the compensation of those engaged in private employment. By such considerations, debtors may be relieved and creditors and stockholders served."⁴⁶ In attempting to arrive at a fair measure of compensation consistent with these notions, at least one novel court employed the annual salary of a federal district court judge as a yardstick.⁴⁷

The Bankruptcy Code liberalized the attorney compensation scheme. Most importantly, it overturned the public interest consideration rule that had sharply curtailed attorney compensation.⁴⁸ The Bankruptcy Code also adjusted the amount an

In re Erewhon, Inc., 21 B.R. 79, 80 (Bankr. D. Mass. 1982); *SEC v. W.L. Moody & Co.*, 374 F. Supp. 465, 481 (S.D. Tex. 1974), *aff'd* 519 F.2d 1087 (5th Cir. 1975); *In re Vicksburg Bridge & Terminal Co.*, 29 F. Supp. 225, 239 (S.D. Miss. 1938).

44. See Brickman & Klein, *supra* note 9, at 1053.

45. *Massachusetts Mut. Life Ins. Co. v. Brock*, 405 F.2d 429, 432 (5th Cir. 1968), *cert. denied*, 395 U.S. 906 (1969); *see, e.g., In re Beverly Crest Convalescent Hospital, Inc.*, 598 F.2d 817, 821 (9th Cir. 1977); *In re York Int'l Bldg., Inc.*, 527 F.2d 1061, 1068 (9th Cir. 1975); *In re Bemporad Carpet Mills, Inc.*, 434 F.2d 988, 989 (5th Cir. 1970); *In re Mabson Lumber*, 394 F.2d 23, 25 (2d Cir. 1968); *In re Delta Food Processing Corp.*, 374 F. Supp. 76, 82 (N.D. Miss. 1974); *In re Yale Express System, Inc.*, 366 F. Supp. 1376, 1381 (S.D.N.Y. 1973).

46. *In re National Dept. Stores*, 11 F. Supp. 633, 638 (D. Del. 1935).

47. See *Official Creditors' Comm. of Fox Mkts., Inc., v. Ely*, 337 F.2d 461, 465-66 (9th Cir. 1964) (citing *Newton v. Consolidated Gas Co.*, 259 U.S. 101, 106 (1922)), *cert. denied*, 380 U.S. 978 (1965); *see also Moshem v. Beverly Crest Convalescent Hosp., Inc. (In re Beverly Crest Convalescent Hosp., Inc.)*, 548 F.2d 817, 820-21 (9th Cir. 1976) (discussing appropriate compensation in light of *York Int'l*); *York Int'l Bldg., Inc. v. Chaney (In re York Int'l Bldg., Inc.)*, 527 F.2d 1061, 1073 (9th Cir. 1975) (discussing compensation in light of federal judges' salaries).

48. The legislative history of § 330 indicates that the House and Senate disagreed about the role that the *Massachusetts Mutual* line of cases should play in determining fees. The House and Senate reports on § 330 offer conflicting views on the importance of "the public interest" and "economy of the estate" as factors to be weighed in considering a fee application. The House wanted a departure from the traditionally meager fees awarded in bankruptcy in order to encourage a strong and competent bankruptcy bar. The Senate wanted to maintain the status quo, reporting:

The reference to "the cost of comparable services" in a nonbankruptcy case is not intended as a change of existing law There is inherent a

attorney could earn for performing bankruptcy services to the amount an attorney would earn for performing comparable nonbankruptcy services,⁴⁹ by requiring attorneys' fee awards to be based on "the cost of comparable services" in fields other than bankruptcy.⁵⁰ Moreover, an attorney seeking compensation from the estate under the Bankruptcy Code must carry the burden of proving that the fee is "reasonable compensation for actual, necessary services" that benefit the estate.⁵¹ To assess the

"public interest" that "must be considered in awarding fees." *Mass. Mutual Life Ins. Co. v. Brock*, 405 F.2d 429, 432 (5th Cir. 1968), *cert. denied*, 395 U.S. 906 (1969).

S. Rep. No. 989, 95th Cong., 2d Sess. 40 (1979), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5826.

The House report made clear that its interpretation prevailed over the Senate interpretation, stating:

Section 330(a) contains the standard of compensation adopted in H.R. 8200 as passed by the House rather than the contrary standard contained in the Senate amendment. Attorneys' fees in bankruptcy cases can be quite large and should be closely examined by the court. However, bankruptcy legal services are entitled to command the same competency of counsel as other cases. In that light, the policy of this section [§ 330] is to compensate attorneys and other professionals serving in a case under title 11 at the same rate as the attorney or other professional would be compensated for performing comparable services other than in a case under title 11. *Contrary language in the Senate report accompanying S. 2266 is rejected, and Mass. Mutual Life Ins. Co. v. Brock*, 405 F.2d 429, 432 (5th Cir. 1968) is overruled. *Notions of economy of the estate in fixing fees are outdated and have no place in a bankruptcy code.*

124 Cong. Rec. H.11089, *reprinted in* 1978 U.S. Code Cong. and Admin. News 6436, 6442 (emphasis added). The House report appears to make clear that the Code rejects *Massachusetts Mutual's* public interest consideration rule, allowing courts to look simply to comparable fees outside of bankruptcy in assessing a fee's reasonableness. Some courts, however, mistakenly continue to cite the Senate report and *Massachusetts Mutual* for the proposition that "public interest" and "economy of the estate" must be considered in awarding fees. *See, e.g., In re Schumann Tire & Battery Co.*, 89 B.R. 223, 228 (Bankr. M.D. Fla. 1988); *In re Henning*, 55 B.R. 682, 684 (Bankr. D.S.D. 1985). At least one court has acknowledged the legislative history's contrary dictate, but nonetheless concluded that "public interest" merits consideration in awarding fees. *In re Gulf Consol. Serv., Inc.*, 91 B.R. 414, 418-20 (Bankr. S.D. Tex. 1988). In short, although the House report unambiguously rejects the *Massachusetts Mutual* approach, some courts have failed to recognize this change, or if they do recognize it, have failed to accept the House's interpretation.

49. Brickman & Klein, *supra*, note 9, at 1056.

50. 11 U.S.C. § 330(a)(1) (1988).

51. *Id.*; *see, e.g., In re Malewicki*, 142 B.R. 353, 356 (Bankr. D. Neb. 1992); *In re NBI, Inc.*, 129 B.R. 212, 219 (Bankr. D. Colo. 1991); *In re Grimes*, 115 B.R. 639, 642 (Bankr. D.S.D. 1990); *In re Yankton College*, 101 B.R. 151, 157 (Bankr. D.S.D. 1989); *In re C & P Auto Transp., Inc.*, 94 B.R. 682, 686 (Bankr. E.D. Cal. 1988); *In re Pettibone Corp.*, 74 B.R. 293, 299 (Bankr. N.D. Ill. 1987); *In re Lindberg Prods., Inc.*, 50 B.R. 220, 221 (Bankr. N.D. Ill. 1985); *In re Minnesota Distillers, Inc.*, 45 B.R. 131, 134 (Bankr. D. Minn. 1984); *In re Harman Super-*

reasonableness of attorneys' fees, section 330 provides that bankruptcy judges should consider the nature, extent, and value of services rendered, the time spent on such services, and the cost of comparable services.⁵² Using these parameters as a guide, courts considering the reasonableness of attorneys' fees have focused on the documented time spent performing specific legal services,⁵³ the nature and complexity of the services rendered,⁵⁴ the quality of advocacy required and delivered,⁵⁵ and

market, Inc., 44 B.R. 918, 920 (Bankr. W.D. Va. 1984); *In re Horn & Hardart Baking Co.*, 30 B.R. 938, 939 (Bankr. E.D. Pa. 1983); *Acceptance Assoc. of America v. Zimmerman (In re H.P. Tool Manufacturing Corp.)*, 12 B.R. 600, 603 (Bankr. E.D. Pa. 1981).

52. 11 U.S.C. § 330(a) (1988).

53. See, e.g., *Southwestern Medica, Inc. v. Rau*, 708 F.2d 419, 426 (9th Cir. 1983) ("For purposes of calculating fees in bankruptcy, the time spent on behalf of the estate is very important in determining what is reasonable and fair . . . [the] attorney should keep accurate records of the time spent on behalf of the estate." (citation omitted)); *In re Malewicki*, 142 B.R. 353, 356 (Bankr. D. Neb. 1992) ("If time records are not kept counsel will not be able to sustain their burden of proof or to file a detailed fee application."); *In re Smith*, 48 B.R. 375, 379 (Bankr. C.D. Ill. 1984) ("The debtor's attorney must provide to the court a detailed account of all the legal services provided to the debtor."); *In re Wilson Foods Corp.*, 40 B.R. 118, 120 (Bankr. W.D. Okla. 1984) ("The starting point for the calculation of fee awards is determining the number of hours reasonably spent multiplied by the hourly rate charged."); *In re Photon*, 26 B.R. 693, 699 (Bankr. D. Mass. 1982) ("A fee applicant must submit a detailed record that will enable the court to calculate the value of the services for which compensation is sought."); *In re Garland Corp.*, 8 B.R. 826, 829 (Bankr. D. Mass. 1981) ("As a starting point, the time spent on the case is of major importance to the courts in passing judgment on fees."); see WILLIAM J. COLLIER, 2 COLLIER ON BANKRUPTCY, ¶ 330, at 337-47 (Lawrence P. King, ed., 15th ed. 1993).

54. *Id.* at 348-49; see, e.g., *In re Warrior Drilling & Eng'g Co.*, 9 B.R. 841, 849 (Bankr. N.D. Ala. 1981) (allowing compensation in excess of usual hourly rates based on the case's complexity, the novel issues of first impression under the Code, and the high degree of skill demonstrated by the attorneys), modified by 18 B.R. 684 (N.D. Ala. 1981); see also *In re Lloyd, Carr & Co.*, 2 B.R. 714, 717 (D. Mass. 1979) ("[L]itigation, before three levels of the Bermuda court system, which demanded a quick and thorough grasp of several distinct bodies of law not ordinarily encountered in even the most sophisticated or specialized . . . practice" justified large compensation as reasonable); *In re White Motor Credit Corporation*, 50 B.R. 885, 890 (Bankr. N.D. Ohio 1985) ("[P]remiums are merited when there are circumstances and factors which warrant consideration in addition to those already employed in computing the applicant's . . . standard fee."); *In re Wilson Foods Corp.*, 40 B.R. 118, 121-22 (Bankr. W.D. Okla. 1984) (holding that attorney merited large fee because the "special skills and experience of counsel for the Committee necessarily would be a time saving factor in novel and complex cases such as this," and the "actual nature of the services have included legal questions and issues on extremely complex commercial, labor, as well as bankruptcy matters."); *In re Bishop*, 32 B.R. 302, 305 (Bankr. D.R.I. 1983) (holding that court decides reasonable hourly rate to reflect a case's particular facts and demands); *In re Idak Corp.*, 26 B.R. 793, 798-800 (Bankr. D. Mass. 1982) (holding that complexity of case warranted 30% increase in the

the costs of comparable services in non-bankruptcy cases.⁵⁶

firm's hourly rate); *Brooks v. Wachman (In re McLean)*, 6 B.R. 327, 328 (Bankr. E.D. Va. 1980) ("What constitutes a reasonable fee . . . will vary from case to case depending upon the complexity of the issues presented.").

55. See, e.g., *Vining v. Ward (In re Ward)*, 894 F.2d 771, 777 (5th Cir. 1990) (holding that court may reevaluate fees where benefit to the estate is uncertain); *In re Reed*, 890 F.2d 104, 105 (8th Cir. 1989) (holding that chapter 11 attorneys' services must benefit estate to be recoverable); *In re Global Int'l Airways Corp.*, 82 B.R. 520, 522 (Bankr. W.D. Mo. 1988) (denying compensation for debtor's general counsel for services performed contrary to the estate's interests); *In re Zweig*, 35 B.R. 37, 38 (Bankr. N.D. Ga. 1983) (allowing compensation only for those services which benefit the estate and not for those benefitting the debtor only in his individual capacity); *In re Jet Executive Int'l*, 34 B.R. 339, 341 (Bankr. S.D. Fla. 1983) ("Applicable law indicates that, in particular where the results obtained are not significant, the fees awarded should be at the low end of the acceptable spectrum."); *In re J.V. Knitting Serv. Inc.*, 22 B.R. 543, 544 (Bankr. S.D. Fla. 1982) ("A debtor's attorney is accorded an administrative priority for compensation upon the premise that his services, to some extent at least, have benefited the administration of the estate."); *In re Tamarack Trail Co.*, 25 B.R. 259, 260 (Bankr. S.D. Ohio 1982) (disallowing a portion of the requested attorney fees on the grounds that the services rendered were of reduced benefit to the estate because creditors ultimately rejected attorneys' proposed plan); *In re Aldersgate Found., Inc.*, 10 B.R. 910, 917 (Bankr. M.D. Fla. 1981) ("Unlike court appointed officers, the attorney for the Debtor is only entitled to compensation to the extent the services rendered present a benefit to the estate."). But see *In re Casco Bay Lines, Inc.*, 25 B.R. 747 (Bankr. 1st Cir. 1982) (holding that the bankruptcy court erred in disallowing fees under narrow and restrictive application of the "benefit to the estate" factor in determining reasonableness); *Kressel v. Kotts (In re Schaffer)*, 34 B.R. 388, 392 (D. Minn. 1983) (holding that, even when the debtor's attorney abandons the case, pre-petition services actually performed and resulting in value to the debtor entitle the attorney to reasonable compensation); *In re Lloyd, Carr & Co.*, 2 B.R. 714, 716 (D. Mass. 1979) ("There is a need to provide realistic compensation as an incentive to the best of the bar to serve the bankruptcy court."); *In re Airlift Int'l, Inc.*, 24 B.R. 128, 130-131 (Bankr. S.D. Fla. 1982) (reducing compensation because firm's work product contained errors and deemed inferior in quality); see also 2 COLLIER, *supra* note 53, ¶ 330, at 350-360.

56. *Neville v. Eufaula Bank & Trust Co. (In re Golf Corp.)*, 639 F.2d 1197, 1201 (5th Cir. 1981) (noting that Bankruptcy Code requires judges to determine appropriate fees in light of the "cost of comparative services" in non-bankruptcy fields); *In re Warrior Drilling & Eng'g Co.*, 9 B.R. 841, 850 (Bankr. N.D. Ala.) ("Consideration must be made to awards in cases in other fields, with similar complexity, size and benefits.") modified by 18 B.R. 684 (N.D. Ala. 1981); *In re Perros*, 14 B.R. 515, 518 (Bankr. E.D.N.Y. 1981), ("[T]he court must also examine the cost of comparable services in nonbankruptcy cases."); *In re City Planners & Developers, Inc.*, 5 B.R. 217, 219 (Bankr. D.P.R. 1980) ("[T]he statute prohibits us from considering similar bankruptcy work, so we must consider similar work in non-bankruptcy fields."); *Brooks v. Nachman (In re McLean)*, 6 B.R. 327, 328 (Bankr. E.D. Va. 1980) ("With the advent of the Bankruptcy Code came the abolition of the economy principle and a time-honored yet curious notion that attorneys practicing in bankruptcy should be paid less than those practicing in other forums."); see 2 COLLIER, *supra* note 53, ¶ 330, at 361-66.

A subsidiary issue that often arises is whether the non-local attorneys should receive the appropriate rate for comparable local services or regional

A number of courts have gone so far as to evaluate the reasonableness of attorney compensation under the Bankruptcy Code by applying the twelve factors enumerated in *Johnson v. Georgia Highway Express, Inc.*,⁵⁷ a decision addressing the awarding of reasonable attorneys' fees to prevailing plaintiffs under the Civil Rights Act of 1964. These twelve factors are as follows:

1. the time and labor required;
2. the novelty and difficulty of the questions presented;
3. the skill requisite to perform the legal service properly;
4. the preclusion of other employment by the attorney due to the acceptance of the case;
5. the customary fee for similar work in the community;
6. whether the fee is fixed or contingent;
7. time pressures imposed by the client or the circumstances;
8. the amount involved and results obtained as a result of the attorney's services;
9. the attorney's experience, reputation and ability;
10. the "undesirability" of the case;
11. the nature and length of the professional relationship with the client; and
12. awards in similar cases.⁵⁸

The Fifth Circuit Court of Appeals expressly made the factors set forth in *Johnson* applicable to bankruptcy cases under the former Bankruptcy Act of 1898 in *In re First Colonial Corp. of*

rates from the non-local attorney's usual practice area. For cases adopting the local yardstick for rates, see, for example, *In re Wendy's of Mont., Inc.*, 111 B.R. 314, 317 (Bankr. D. Mont. 1990); *In re Gulf Consol. Serv., Inc.*, 91 B.R. 414, 420 (Bankr. S.D. Tex. 1988); *In re Seneca Oil Co.*, 65 B.R. 902, 911 (Bankr. W.D. Okla. 1986); *Unsecured Creditors' Comm. of Pacific Express, Inc. v. Pioneer Commercial Funding Corp.* (*In re Pacific Express, Inc.*), 56 B.R. 859, 864 (Bankr. E.D. Cal. 1985); *In re Global Int'l Airways Corporation*, 38 B.R. 440, 443 (Bankr. W.D. Mo. 1984); *In re Sutherland*, 14 B.R. 55, 58 (Bankr. D. Vt. 1981).

For cases applying the regional rate, see, for example, *In re Washington Mfg.*, 101 B.R. 944, 952 (Bankr. M.D. Tenn. 1989); *In re Temple Retirement Community, Inc.*, 97 B.R. 333, 343 (Bankr. W.D. Tex. 1989); *In re Yankton College*, 101 B.R. 151, 160 (Bankr. D.S.D. 1989); *In re Public Serv. Co.*, 86 B.R. 7, 10-11 (Bankr. D.N.H. 1988); *In re Frontier Airlines, Inc.*, 74 B.R. 973, 977 (Bankr. D. Colo. 1987); *In re Baldwin United Corp.*, 36 B.R. 401, 402 (Bankr. S.D. Ohio 1984); *In re Wilson Foods Corp.*, 36 B.R. 317, 321 (Bankr. W.D. Okla. 1984).

57. 488 F.2d 714 (5th Cir. 1974).

58. *Id.* at 717-19.

America.⁵⁹ As the Fifth Circuit explained, although *Johnson* involved an award of attorneys' fees under Title VII, the twelve *Johnson* factors applied to bankruptcy cases because "the guidelines we established there are equally useful whenever the award of reasonable attorneys' fees is authorized by statute."⁶⁰ Other courts have subsequently embraced the *Johnson* test under the Bankruptcy Code.⁶¹

In addition to overturning the public interest consideration rule, Congress, in the Bankruptcy Code, also eliminated caps on total attorney compensation,⁶² and heretofore, allowed the market to dictate appropriate attorney compensation. Finally, as noted above, the Bankruptcy Code included a provision for interim attorney compensation so that attorneys would not have to await the case's conclusion to be compensated. Under the Bankruptcy Code, an attorney may now apply for interim compensation every 120 days during the case.⁶³

59. 544 F.2d 1291 (5th Cir. 1977).

60. *Id.* at 1299; see 2 COLLIER, *supra* note 53, ¶ 330, at 334-35.

61. See e.g., *Grant v. George Schumann Tire & Battery Co.*, 908 F.2d 874, 879 (11th Cir. 1990); *Neville v. Eufaula Bank & Trust Co. (In re U.S. Golf Corp.)*, 639 F.2d 1197, 1205 (5th Cir. 1981); *Rose Pass Mines, Inc. v. Howard*, 615 F.2d 1088, 1091 (5th Cir. 1980); *In re Lloyd, Carr & Co.*, 2 B.R. 714, 717, n.1 (D. Mass. 1979); *In re Malewiski*, 142 B.R. 353, 355 (Bankr. D. Neb. 1992); *In re Santoro Excavating, Inc.*, 56 B.R. 546, 550 (Bankr. S.D.N.Y. 1986); *In re Pacific Express, Inc.*, 56 B.R. 859, 862 (Bankr. E.D. Ca. 1985); *In re Lloyd A. Smith*, 48 B.R. 375, 378 (Bankr. C.D. Ill. 1984); *In re Jones*, 13 B.R. 192, 194 (Bankr. E.D. Va. 1981); *In re James Calvin Belk Const. Co.*, 11 B.R. 56, 58 (Bankr. N.D. Miss. 1981); *In re Warrior Drilling & Eng'g Co.*, 9 B.R. 841, 848 (Bankr. N.D. Ala. 1981), *modified by* 18 B.R. 684 (N.D. Ala. 1981); *In re Garland Corp.*, 8 B.R. 826, 831 (Bankr. D. Mass. 1981). *But see In re Casco Bay Lines, Inc.*, 25 B.R. 747, 754 (1st Cir. 1982) (criticizing *Johnson* approach); *In re Four Star Terminals, Inc.*, 42 B.R. 419, 430 (Bankr. Alaska 1984)(same).

62. See 11 U.S.C. § 330(a) (1988) (providing that attorneys' fees must be "reasonable"); 124 Cong. Rec. 32,394-95 (1978) (stating that policy of § 330 is to compensate bankruptcy attorneys at the same rates as attorneys performing non-bankruptcy services); see also *Boddy v. United States (In re Boddy)*, 950 F.2d 334, 337 (6th Cir. 1991) (holding that a fixed maximum rate for attorneys is inconsistent with Bankruptcy Code); *Neville v. Eufaula Bank & Trust Co. (In re U.S. Golf Corp.)*, 639 F.2d 1197, 1205-06 (5th Cir. 1981) (holding that district court policy limiting attorney fees overrides the *Johnson* factors and is therefore inconsistent with the proper procedure for assessing fees); *In re Costello*, 150 B.R. 675, 678 (Bankr. E.D. Ky. 1992) ("[G]enerally the lodestar formula should be applied in awarding fees. . ."); *In re Malewiski*, 142 B.R. 353, 356-57 (Bankr. D. Neb. 1992) ("[B]ankruptcy courts are no longer bound by pre-Bankruptcy Code notions of frugality and economy in fixing fees.").

63. See 11 U.S.C. § 331 (1988); BANKR. R. 2016(a) (governing procedures on compensation for services rendered and reimbursement of expenses).

B. RETAINER AGREEMENTS

Prior to commencing a business reorganization under the Bankruptcy Code, the debtor's attorneys⁶⁴ often obtain retainer agreements and fees to compensate and reimburse them throughout the case. Most simply, a retainer agreement is an agreement to actually or potentially perform legal services for a client. As one bankruptcy court has noted, "[g]iven the proliferation of bankruptcy filings and the increased complexity of the newer Chapter 11 filings . . . it is neither surprising nor unreasonable that such retainers would be required before counsel would undertake the arduous task of guiding a debtor through a complicated reorganization laden with risk."⁶⁵

Generally, two broad categories of retainer agreements exist: the classic retainer and the special retainer.⁶⁶ In a classic (or general) retainer agreement, the client agrees to pay a fixed sum in exchange for the attorney's promised availability to perform legal services that may arise during a specific period of time.⁶⁷ A classic retainer functions both as a payment "to bind the attorney from representing another" and as a payment "for accepting the case."⁶⁸ Because the consideration for a classic retainer is paid in exchange for availability, it is a charge separate from the fees incurred for services actually performed.⁶⁹ "[A]n essential characteristic of the classic retainer is that it is earned

64. At least one bankruptcy court has stated that a "substantial argument" exists that under "appropriate circumstances" professionals employed by a statutory creditors' committee may also obtain a retainer from the debtor's estate. *In re* 1606 New Hampshire Ave. Assoc., 96 B.R. 406, 406 (Bankr. D. D.C. 1989).

65. *In re* Chapel Gate Apartments, Ltd., 64 B.R. 569, 572 (Bankr. N.D. Tex. 1986). Under the Bankruptcy Code, a debtor's attorney must disclose the terms of any prepetition retainer agreement to the court even though no further compensation will be sought from the estate. 11 U.S.C. § 329(a) (1988); see *In re* Arlan's Dep't Stores, Inc., 615 F.2d 925, 936 (2d Cir. 1979). Additionally, notwithstanding any prepetition receipt of funds pursuant to a retainer agreement, an attorney may have to file a fee application with the court detailing the use of such funds. See *In re* Burnside Steel Foundry Co., 19 C.B.C.2d 761 (N.D. Ill. 1988).

66. *In re* GOCO Realty Fund I, 151 B.R. 241, 250-51 n.11 (Bankr. N.D. Cal. 1993).

67. *Baranowski v. State Bar*, 593 P.2d 613, 618 n.4 (Cal. 1979); *Jacobson v. Sassower*, 452 N.Y.S.2d 981, 983-84 (N.Y. Civ. Ct. 1982), *aff'd*, 474 N.Y.S.2d 167 (N.Y. App. Term 1983), *aff'd*, 483 N.Y.S.2d 711 (N.Y. App. Div.), *aff'd*, 489 N.E.2d 1283 (1985) ("[P]ayment of a preliminary fee may be made solely to receive whatever professional services a client may request during a fixed period. This is called a 'true,' or 'general retainer' . . .").

68. *In re* McDonald Bros. Constr., Inc., 114 B.R. 989, 998-99 (Bankr. N.D. Ill. 1990); *Jacobs v. Holston*, 434 N.E.2d 738, 741 (Oh. Ct. App. 1980).

69. *Brickman & Klein*, *supra* note 9, at 1066-67.

entirely by the attorney upon payment, with the client retaining no interest in the funds."⁷⁰ Thus, although the Bankruptcy Code requires an attorney to disclose the receipt of a classic retainer payment pursuant to section 329,⁷¹ she is not subject to the more demanding notice and hearing requirements of section 330.⁷²

Not surprisingly, parties frequently use classic retainers in bankruptcy because of their "earned-upon-receipt" quality.⁷³ This use of the classic retainer agreement to assure postpetition availability is sometimes legitimate. More often, however, attorneys use it to evade the bankruptcy court's scrutiny by denominating a special retainer advance fee as a classic retainer.⁷⁴

Using these retainers in this manner presents several problems. Foremost, cognizant of this practice, many courts reject attempts to disguise advance fees as classic retainers.⁷⁵ Moreover, commentators have argued that the use of classic retainers in the bankruptcy context is inappropriate because it induces attorneys to exaggerate "the value of their availability."⁷⁶ Finally, as detailed below, these retainers may be subject to at-

70. *McDonald Bros.*, 114 B.R. at 999; *In re C & P Auto Transp., Inc.*, 94 B.R. 682, 687 (Bankr. E.D. Cal. 1988).

71. Indeed, the court can order an attorney to repay a classic retainer agreement if it exceeds reasonable value. 11 U.S.C. § 329 (1988).

72. 11 U.S.C. § 330(a) states:

After notice to any parties in interest and to the United States trustee and a hearing, and subject to sections 326, 328, and 329 of this title, the court may award to a trustee, to an examiner, to a professional person employed under section 327 or 1103 of this title, or to the debtor's attorney—

(1) reasonable compensation for actual, necessary services rendered by such trustee, examiner, professional person, or attorney, as the case may be, and by any paraprofessional persons employed by such trustee, professional person, or attorney, as the case may be, based on the nature, the extent, and the value of such services, the time spent on such services, and the cost of comparable services other than in a case under this title; and

(2) reimbursement for actual, necessary expenses.

11 U.S.C. § 330(a) (1988).

73. *Brickman & Klein*, *supra* note 9, at 1074.

74. *See, e.g., In re NBI, Inc.*, 129 B.R. 212, 223 n.11 (Bankr. D. Colo. 1991).

75. *Id.*

76. *Brickman & Klein*, *supra* note 9, at 1075. As one bankruptcy court has noted in this regard:

A true earned upon receipt retainer is one paid to a lawyer for which the only consideration exchanged is the promise to represent the client and no other party in the particular matter. The consideration cannot include logically the provision of future services if the retainer is truly earned upon receipt. I find there is little or no value in a professional's mere promise to represent a debtor in possession and no other party in a bankruptcy case. The value of such a promise is negligible, absent

tack in bankruptcy. Under section 548, a trustee can avoid any transfer of a debtor's interest for which the debtor receives "less than a reasonably equivalent value" in return.⁷⁷ Because "an unperformed promise to furnish support to [a] debtor" at least arguably does not constitute "value" under section 548,⁷⁸ the validity of all prepetition classic retainers remains open to question.

A special retainer, by contrast, is an agreement in which an attorney promises to perform specific legal services. Two general types of special retainers exist: a security retainer and an advance fee retainer. In a security retainer, the attorney holds the retainer "to secure payment of fees for future services."⁷⁹ The funds do not constitute a present payment for future services, but rather "remain the property of the debtor until the attorney 'applies' it to charges for services actually rendered."⁸⁰ Accordingly, the attorney must return any unearned portion of the retainer.⁸¹ "[B]ecause the debtor continues to hold an interest in security retainers, . . . [they] . . . can only be used by debtor's counsel upon compliance with the entire fee application process, including court approval."⁸²

Notably, the term "security retainer" is something of a misnomer. For a security retainer to exist there must be some se-

extraordinary circumstances. The true value provided by the professional is the provision of actual, necessary and effective services.

In re Hathaway Ranch Partnership, 116 B.R. 208, 216 (Bankr. C.D. Cal. 1990) (citation omitted).

77. 11 U.S.C. § 548 (1988), amended by 11 U.S.C. § 548(d)(2)(Supp. II 1990).

78. 11 U.S.C. § 548(d)(2)(A) (1988); see *In re Investment Bankers, Inc.*, 4 F.3d 1556, 1565 (Bankr. 10th Cir. 1993) (holding that payment of \$25,000 retainer made to an attorney one week before bankruptcy was a fraudulent transfer under §§ 548 and 329); *Bailey v. Metzger, Shadyac & Schwartz* (*In re Butcher*), 72 B.R. 447, 450 (Bankr. E.D. Tenn. 1987) (finding that attorney's "agreement to perform future legal services on behalf of [the debtor] . . . is outside the scope of 'value' as defined in § 548"); see also, *FDIC v. Cafritz*, 762 F. Supp. 1503, 1507 (D. D.C. 1991); *In re Daddy's Money of Clearwater, Inc.*, 155 B.R. 788, 792 (Bankr. M.D. Fla. 1993); *In re Hathaway Ranch Partnership*, 116 B.R. 208, 219 (Bankr. C.D. Cal. 1990); *In re Day Telecommunications*, 70 B.R. 904, 911 (Bankr. E.D.N.C. 1987).

79. *In re McDonald Bros. Constr., Inc.*, 114 B.R. 989, 998-99 (Bankr. N.D. Ill. 1990).

80. *Id.*

81. *Id.*

82. *Id.* at 1000; see *In re Burnside Steel Foundry*, 90 B.R. 942, 945 n.1 (Bankr. N.D. Ill. 1988) ("[I]f the retainer is of the security type . . . ownership of the retainer remains in the debtor even after the petition is filed . . . [and] the right to keep the retainer ultimately turns on the filing and approval of a fee application under § 330 of the Code.").

curity for payment of the lawyer's fee. In actuality, however, usually the collateral secures nothing: the security retainer does not secure the payment of compensation.⁸³ Thus, the security retainer does not create a secondary obligation to which the attorney can look for satisfaction.⁸⁴ Rather, in most cases, it serves as an advance fee payment which secures nothing. It is not security for payment; it is payment.⁸⁵

In an advance fee retainer arrangement, the client pays the attorney in advance for contemplated legal services and the attorney depletes the prepayment as she renders services.⁸⁶ If the attorney completes the matter before earning the entire advance fee, the attorney must refund the balance to the client.⁸⁷ Advance fee retainers differ from security retainers in that "ownership of the retainer is intended to pass to the attorney at the time of the payment, in exchange for the commitment to provide the legal services."⁸⁸

Significantly, the enforceability of advance payment retainers is currently unsettled. Some critics contend that state-enforced ethical canons prevent an attorney from accepting an advance payment of fees, maintaining that any payment by a client for legal services should be regarded as the client's funds until the attorney actually performs the services.⁸⁹

II. A SECURED PARTY'S CHALLENGES TO ATTORNEYS' FEES

A secured party can offer two separate challenges to the payment of attorneys' fees in bankruptcy: a direct challenge or

83. Brickman & Klein, *supra* note 9, at 1047.

84. As Brickman and Klein posit, one could devise a security retainer that would apply in the bankruptcy context. *Id.* at 1071 n.172.

85. *Id.* at 1071-72.

86. See, e.g., *In re Fulton*, 80 B.R. 1009, 1010 (Bankr. D. Neb. 1988) (noting that debtor paid attorney flat fee of \$2,000 for all work to be performed in Chapter 12 case); *In re Chapel Gate Apartments, Ltd.*, 64 B.R. 569, 579 (Bankr. N.D. Tex. 1986) (setting forth a retainer agreement which stated that the retainer is "fully earned and nonrefundable upon its payment and receipt" and that the client "will be entitled to services to be provided by this firm at the hourly rates specified . . . up to the full amount of the retainer").

87. MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.5 cmt (1983).

88. *In re McDonald Bros. Constr., Inc.*, 114 B.R. 989, 999-1000 (Bankr. N.D. Ill. 1990).

89. See Lester Brickman, *The Advance Fee Payment Dilemma: Should Payments Be Deposited to the Client Trust Account or to the General Office Account?*, 10 CARDOZO L. REV. 647 (1989) (arguing that advance payment retainers are unethical). But see N.Y. State Bar Ass'n. Comm. on Professional Ethics, Op. 570 (1985) (approving advance fee retainers).

an indirect challenge. In making a direct challenge to the payment of such fees, the secured party claims that the recipient of fees paid from the proceeds of secured collateral thereby converts the secured party's collateral. In an indirect challenge, the secured party argues that payment to the recipient meets the requirements of a voidable preference under section 547(b) or a fraudulent transfer under section 548 of the Bankruptcy Code.

A. CONVERSION OF SECURED PARTY'S COLLATERAL

It is axiomatic that a debtor retains the power to sell or otherwise dispose of collateral,⁹⁰ thereby transferring her interest in the property, despite provisions in the security agreement that purport to limit her ability to convey collateral.⁹¹ The debtor's disposition of the collateral, however, does not terminate the security interest, because a security interest generally continues in collateral notwithstanding the sale or other disposition of such collateral.⁹² Thus, although a debtor can transfer secured collateral, the property remains subject to the security interest and continues to be collateral for the debt owed the secured party.⁹³

Additionally, to the extent a secured party has a security interest in collateral, this entitlement continues in whatever the debtor receives when she sells or otherwise disposes of the collateral.⁹⁴ A secured party's rights in collateral extend to the

90. Collateral is defined as "property subject to a security interest" U.C.C. § 9-105(1)(c).

91. "The debtor's rights in collateral may be . . . transferred . . . notwithstanding a provision in the security agreement prohibiting any transfer or making the transfer constitute a default." U.C.C. § 9-311.

92. U.C.C. § 9-306(2).

93. See, e.g., *Harley-Davidson Motor Corp. v. Bank of New England*, 897 F.2d 611, 617 (1st Cir. 1990); *Northern Commercial Co. v. Cobb*, 778 P.2d 205, 207 (Alaska 1989); *American Heritage Bank & Trust Co. v. O.&E., Inc.*, 576 P.2d 566, 568 (Colo. App. 1978); *Riney v. Weiss & Neuman Shoe Co.*, 577 N.E.2d 505, 508 (Ill. App. Ct. 1991); *Decatur Prod. Credit Ass'n v. Murphy*, 456 N.E.2d 267, 274 (Ill. App. Ct. 1983); *Larsen v. Warrington*, 348 N.W.2d 637, 640 (Iowa Ct. App. 1984); *Farmers State Bank of Delevan v. Easton Farmers Elevator*, 457 N.W.2d 763, 766 (Minn. Ct. App. 1990); *Swift County Bank v. United Farm Elevators*, 366 N.W.2d 606, 608 (Minn. Ct. App. 1985); *Sturdevant v. First Sec. Bank*, 606 P.2d 525, 528 (Mont. 1980); *Whirlpool Corp. v. Dailey Const., Inc.*, 429 S.E.2d 748, 750 (N.C. Ct. App. 1993); *Bank of Virginia-Central v. Taurus Const. Co.*, 226 S.E.2d 685, 688 (N. C. Ct. App. 1976); *Chrysler Credit Corp. v. Ferguson Pontiac-GMC*, 853 P.2d 1282, 1283-84 (Okla. Ct. App. 1993); *Production Credit Ass'n v. Nowatzki*, 280 N.W.2d 118, 121 (Wis. 1979); *First Nat'l Bank v. First Interstate Bank*, 774 P.2d 645, 650 (Wyo. 1989); *Frantz v. First Nat'l Bank & Trust Co.*, 687 P.2d 1159, 1161 (Wyo. 1984).

94. U.C.C. § 9-306(2).

proceeds received upon the disposition of the collateral. Thus, if a secured party has a security interest in the debtor's "existing and after-acquired inventory"⁹⁵ and the debtor sells the inventory, the secured party retains a security interest in the sale proceeds. Furthermore, section 9-306(3) provides for the automatic perfection of the security interest in proceeds.⁹⁶ Under section 9-306(3), a security interest in proceeds is "continuously perfected . . . if the security interest in the original collateral was perfected."⁹⁷ This protects a secured party's interest from other intervening creditors.

On a practical level, continuing the security interest in the proceeds of secured collateral makes sense. Proceeds are merely an economic substitute for the original secured collateral. This system works to assure and preserve the certainty of the secured party's investment. What happens, however, if the debtor defaults on her obligations under the security agreement?⁹⁸

Suppose, for example, that the debtor fails to make her debt payments when they come due for four consecutive months, and an event of default occurs under the security agreement. In such an instance, the secured party may take possession of the collateral.⁹⁹ This right of repossession is enforceable not only against the debtor, but also against a buyer or other subsequent transferee of the property either by peaceable self-help¹⁰⁰ or ju-

95. "[A] security agreement may provide that any or all obligations covered by the security agreement are to be secured by after-acquired collateral." U.C.C. § 9-204(1).

96. U.C.C. § 9-306(3).

97. *Id.*

98. The Uniform Commercial Code does not define "default." Rather, a "default" is "whatever the security agreement says it is." 2 GRANT GILMORE, *SECURITY INTERESTS IN PERSONAL PROPERTY* § 43.3, at 1193 (1965); *see also* Harley-Davidson Motor Corp. v. Bank of New England, 897 F.2d 611, 617 (1st Cir. 1990); Brown v. Weeres Indus., Inc., 375 N.W.2d 64, 67 (Minn. Ct. App. 1985); First Nat'l Bank v. Beug, 400 N.W.2d 893, 897 (S.D. 1987) (holding that parties' contract defines default); Production Credit Ass'n of Madison v. Nowatski, 280 N.W.2d 118, 122 (Wisc. 1979).

99. U.C.C. § 9-503.

100. "In taking possession a secured party may proceed without judicial process if this can be done without breach of the peace . . ." U.C.C. § 9-503; *see, e.g.,* Williams v. Ford Motor Credit Co., 674 F.2d 717, 719 (8th Cir. 1982); Thompson v. Ford Motor Credit Co., 550 F.2d 256, 258 (5th Cir. 1977); Coleman v. Block, 562 F. Supp. 1353, 1363 (D.N.D. 1983); Pleasant v. Warrick, 590 So. 2d 214, 216 (Ala. 1991); Jackson v. GMAC, 549 So. 2d 38, 39 (Ala. 1989); Get It Kwik of Am., Inc. v. First Ala. Bank, 361 So. 2d 568, 573 (Ala. Civ. App. 1978) (dictum); Ford Motor Credit Co. v. Ditton, 295 So. 2d 408, 411 (Ala. Civ. App. 1974); Streule v. Gulf Fin. Corp., 265 A.2d 298, 305 (D.C. 1970); Interfirst Bank v. Hanson, 395 N.W.2d 857, 860 (Iowa 1986); Sturdevant v. First Sec. Bank, 606 P.2d 525, 528 (Mont. 1980); MBank El Paso v. Sanchez, 836 S.W.2d 151,

dicial action,¹⁰¹ including both replevin, and claim and delivery.¹⁰² Moreover, a secured party can exercise this right of

152 (Tex. 1992); *Phil Phillips Ford, Inc. v. St. Paul Fire & Marine Ins. Co.*, 465 S.W.2d 933, 939 (Tex. 1971); *Salisbury Livestock Co. v. Colorado Central Credit Union*, 793 P.2d 470, 473 (Wyo. 1990).

Under pre-Code law, conditional vendors and chattel mortgagees also had the right in most cases to effect peaceable self-help repossession, *see* 2 L. JONES, *THE LAW OF CHATTEL MORTGAGES AND CONDITIONAL SALES* § 705 (6th ed. 1933); 3 JONES, *supra*, §§ 1337-1340, and could exercise this right against the debtor's transferees. *See, e.g.*, *Cook & Sons Equip. v. Killen*, 277 F.2d 607, 612 (9th Cir. 1960); *Hinds v. Commercial Credit Co.*, 114 So. 673, 673 (Ala. Ct. App. 1928); *Union Trust Co. v. Advance Loan Co.*, 483 P.2d 396, 397 (Colo. Ct. App. 1971); *Swain v. Schild*, 117 N.E. 933, 935 (Ind. App. 1917); *Huettnner v. Savings Bank*, 219 A.2d 559, 561 (Md. 1966); *Hodes v. Mooney*, 152 A. 205, 206 (N.J. Sup. Ct. 1930), *rev'd on other grounds*, 152 A. 206 (N.J.); *Kroeger v. Ogsden*, 429 P.2d 781, 785 (Okla. 1967); *Haworth v. Jackson*, 178 P. 926, 928 (Or. 1919); *Commercial Credit Corp. v. Harris*, 227 S.W.2d 886, 888 (Tex. Civ. App. 1950).

101. U.C.C. § 9-503; *see, e.g.*, *Del's Big Saver Foods, Inc. v. Carpenter Cook, Inc.*, 795 F.2d 1344, 1348 (7th Cir. 1986); *ITT Terryphone Corp. v. Modems Plus*, 320 S.E.2d 784, 786 (Geo. App. Ct. 1984); *Massey-Ferguson Credit Corp. v. Peterson*, 626 P.2d 767, 773 (Idaho 1981); *Benshoter v. First Nat'l Bank*, 542 P.2d 1042, 1049 (Kan. 1975); *Dungan v. Moore*, 463 So. 2d 1094, 1098 (Miss. 1985); *State v. Hinchey*, 374 N.W.2d 14, 19 (Neb. 1985); *Honstein Trucking v. Sandhills Beef, Inc.*, 308 N.W.2d 331, 335 (Neb. 1981); *MBank El Paso v. Sanchez*, 836 S.W.2d 151, 152 (Tex. 1992).

102. *See, e.g.*, *Strick Corp. v. Eldo-Craft Boat Co.*, 479 F. Supp. 720, 726 (W.D. Ark. 1979); *Kimmel v. Keefe*, 9 Cal. App. 3d 402, 406-07 (Cal. Ct. App. 1970); *Midland-Guardian Co. v. Hagin*, 370 So. 2d 25, 27-28 (Fla. Dist. Ct. App. 1979); *Commercial Credit Equip. Corp. v. Bates*, 267 S.E.2d 469, 472 (Ga. Ct. App. 1980), *appeal on remand*, 285 S.E.2d 560 (1981); *General Motors Acceptance Corp. v. Troville*, 6 U.C.C. Rep. Serv. (Callaghan) 409, 412-13 (Mass. App. Ct. 1969); *Gorham v. Denha*, 258 N.W.2d 196, 199-200 (Mich. Ct. App. 1977); *Garden City Prod. Credit Ass'n v. Lannan*, 186 N.W.2d 99, 102 (Neb. 1971); *MGD Graphic Sys. v. New York Press Publishing Co.*, 383 N.Y.S.2d 606, 608 (N.Y. App. Div. 1976), *aff'd*, 368 N.E.2d 835 (N.Y. 1977); *Paccar Fin. Corp. v. Harnett Transfer, Inc.*, 275 S.E.2d 243, 248-49 (N.C. Ct. App. 1981); *Ellard v. Green Mach. Co.*, 10 U.C.C. Rep. Serv. (Callaghan) 1243, 1245-46 (Okla. Ct. App. 1972); *Karp Bros. v. West Ward S & L Ass'n*, 271 A.2d 493, 496 (Pa. 1970); *O.M. Scott Credit Corp. v. Apex, Inc.*, 198 A.2d 673, 676 (R.I. 1964); *Stephenson Fin. Co. v. Bruce*, 174 S.E.2d 750, 752 (S.C. 1970); *Mill-Morris Automotive v. Baskin*, 462 S.W.2d 486, 487 (Tenn. 1971); *Montgomery v. Fuquay-Mouser, Inc.*, 567 S.W.2d 268, 270 (Tex. Civ. App. 1978).

Pre-Code conditional vendors and chattel mortgagees also had the right to repossess by action. *See, e.g.*, *Forest Inv. Corp. v. Commercial Credit Corp.*, 122 So. 2d 131, 133 (Ala. 1960); *Worthington v. A.G. Rhodes & Son Co.*, 39 So. 614, 614 (Ala. 1905); *Fairbanks, Morse & Co. v. Parker*, 269 S.W. 42, 43 (Ark. 1925); *Liver v. Mills*, 101 P. 299, 300 (Cal. 1909); *Montgomery v. Grattan*, 320 P.2d 106, 108 (Cal. Ct. App. 1958); *Reavis v. Stockel*, 208 P.2d 94, 95 (Colo. 1949); *Stein v. Moskowitz*, 103 A.2d 809, 811 (Conn. 1954); *General Motors Acceptance Corp. v. Elder*, 163 N.E.2d 721, 725-26 (Ill. App. Ct. 1960); *Ohio Sav. Bank & Trust Co. v. Schneider*, 211 N.W. 248, 249 (Iowa 1927); *National Cash Register Co. v. Pfeifer*, 88 P.2d 1032, 1034 (Kan. 1939); *Hoe v. Rex Mfg. Co.*, 91 N.E. 154, 155 (Mass. 1910); *Goodwill Indus. v. Whitsitt*, 116 N.W.2d 783, 786 (Mich.

repossession not only against the debtor's immediate transferee, but also against remote transferees of the property.¹⁰³

1962); *Farmer's Nat'l Bank v. Scheidt*, 141 N.W. 103, 104 (Minn. 1913); *Cleary v. Morson*, 48 So. 817, 817 (Miss. 1909); *General Motors Acceptance Corp. v. Vanausdall*, 249 S.W.2d 1003, 1007 (Mo. Ct. App. 1952); *Bennett Bros. Co. v. Tam*, 62 P. 780, 782-83 (Mont. 1900); *Sheridan v. Dudden Implement, Inc.*, 119 N.W.2d 64, 67-68 (Neb. 1962); *John W. Snyder, Inc. v. Aker*, 236 N.Y.S. 28, 30-31 (N.Y. Sup. Ct. 1929); *Rock Island Plow Co. v. Western Implement Co.*, 132 N.W. 351, 352 (N.D. 1911); *Keller v. Evans*, 14 Ohio App. 265, 267 (Ohio Ct. App. 1920); *Rozen v. Mannford State Bank*, 58 P.2d 119, 121 (Okla. 1936); *Gibson Oil Co. v. Hayes Equip. Mfg. Co.*, 21 P.2d 17, 19-20 (Okla. 1933); *Clow Gas-team Heating Co. v. Hixson*, 67 S.W.2d 619, 620-21 (Tex. Civ. App. 1934); *Taylor Bros. Co. v. Duden*, 188 P.2d 995, 997 (Utah 1948); *MacCallum-Donahoe Fin. Co. v. Warren*, 210 P. 368, 369-70 (Wash. 1922); *Auto Sales Co. v. Yost*, 113 S.E. 758, 759 (W. Va. 1922); *Savage v. Pratt*, 74 N.W.2d 635, 637-38 (Wis. 1956).

In a replevin action, a successful plaintiff can ordinarily recover damages for detention and depreciation if he can prove such losses. See J. COBBEY, A PRACTICAL TREATISE ON THE LAW OF REPLEVIN § 853 (1890); RESTATEMENT (SECOND) OF TORTS § 922 cmt. b (1976); see, e.g., *Garoogian v. Medlock*, 592 F.2d 997, 1001-02 (8th Cir. 1979); *White Motor Credit Corp. v. Sapp Bros. Truck Plaza*, 249 N.W.2d 489, 494 (Neb. 1977). But see *Strick Corp. v. Eldo-Craft Boat Co.*, 479 F. Supp. 720, 726 (W.D. Ark. 1979); *Higgins v. Guerin*, 245 P.2d 956, 959 (Ariz. 1952). *Guerin* highlights a fundamental difficulty with awarding a secured party damages for detention when she replevies collateral from a transferee: to recover, the plaintiff must show that she had a right to use the property and that she would have used it during the time the defendant detained it. *Id.* at 958-59. A secured creditor, however, ordinarily repossesses collateral to dispose of it, not to use it.

103. See, e.g., *Swift v. J.I. Case Co.*, 266 So. 2d 379, 380-81 (Fla. Dist. Ct. App.), cert. denied, 271 So. 2d 147 (Fla. 1972); *Commercial Credit Equip. Corp. v. Bates*, 267 S.E.2d 469, 472 (Ga. Ct. App. 1980), appeal on remand, 285 S.E.2d 560 (1981); *General Motors Acceptance Corp. v. Troville*, 6 U.C.C. Rep. Serv. (Callaghan) 409, 412-13 (Mass. App. Ct. 1969); *Gorham v. Denha*, 258 N.W.2d 196, 199 (Mich. Ct. App. 1977); *Exchange Bank v. Jarrett*, 588 P.2d 1006, 1008 (Mont. 1979); *Garden City Prod. Credit Ass'n v. Lannan*, 186 N.W.2d 99, 102-03 (Neb. 1971); *National Shawmut Bank v. Jones*, 236 A.2d 484, 485-86 (N.H. 1967); *Ocean County Nat'l Bank v. Palmer*, 457 A.2d 1225, 1228 (Sup. Ct. N.J. 1983); *Marine Midland Bank, N.A.V. v. Smith Boys, Inc.*, 429 N.Y.S.2d 355, 359 (N.Y. Sup. Ct. 1985); *Macri v. First Nat'l Bank*, 10 U.C.C. Rep. Serv. (Callaghan) 227, 230 (Okla. Ct. App. 1972); *Phil Phillips Ford, Inc. v. St. Paul Fire & Marine Ins. Co.*, 465 S.W.2d 933, 934 (Tex. 1971) (by implication); *Frantz v. First Nat'l Bank & Trust Co.*, 687 P.2d 1159, 1161 (Wyo. 1984).

Under pre-Code law, too, conditional vendors and chattel mortgagees could pursue their collateral in the hands of remote transferees. See, e.g., *Guerin v. Higgins*, 218 P.2d 870, 871 (Ariz. 1950) (by implication); *Pugh v. Camp*, 210 S.W.2d 120, 121 (Ark. 1948); *Bice v. Harold L. Arnold, Inc.*, 243 P. 468, 470 (Cal. Ct. App. 1925); *Dicks v. Colonial Fin. Corp.*, 85 So. 2d 874, 876 (Fla. 1956); *Huey v. La Grange Motors*, 52 S.E.2d 45, 45 (Ga. Ct. App. 1949) (by implication); *Cable Co. v. McElhoe*, 108 N.E. 790, 793 (Ind. Ct. App. 1915); *Macheak v. Adamsen*, 239 N.W. 574, 575 (Iowa 1931); *Associates Discount Corp. v. Bogard*, 86 So. 2d 76, 78 (La. 1956); *Marsh v. S.M.S. Co.*, 194 N.E. 97, 99 (Mass. 1935); *Mid-Continent Fin. Corp. v. Grant*, 58 So. 2d 1, 5 (Miss.), modified on other

In some cases, however, a secured party may be reluctant to assume the risks of liability associated with retaking the collateral from a transferee, or she may discover that the transferee has already disposed of the collateral and may be unwilling or unable to trace it to the ultimate transferee. In these circumstances, the secured party's alternative to retaking the original collateral is to sue the transferee for unlawfully converting it. Courts have in numerous cases recognized a conversion action as a means of enforcing an Article 9 secured party's priority over a transferee of the collateral.¹⁰⁴ The drafters of Article 9 also

grounds, 59 So. 2d 272 (Miss. 1952); Toledo Computing Scale Co. v. Aubuchon, 173 S.W. 85, 86 (Mo. Ct. App. 1915); General Motors Acceptance Corp. v. Burger, 192 A. 364, 365 (N.J. Sup. Ct. 1937); General Motors Acceptance Corp. v. Schwartz, 190 A. 625, 626 (N.J. Sup. Ct.), *aff'd per curiam*, 194 A. 183 (N.J. 1937); General Motors Acceptance Corp. v. Glammarino, 274 N.Y.S. 2d 618, 620 (N.Y. Civ. Ct. 1966); Friendly Fin. Corp. v. Quinn, 61 S.E.2d 192, 194 (N.C. 1950); General Fin. Corp. v. Jackson, 296 P.2d 141, 145-46 (Okla. 1956); Vicars v. Atlantic Discount Co., 140 S.E.2d 667, 672 (Va. 1965); Cash Loan Co. v. Boser, 149 N.W.2d 605, 609 (Wis. 1967).

104. See, e.g., *United States v. Tugwell*, 779 F.2d 5, 7 (4th Cir. 1985); *Taylor Rental Corp. v. S.F. Case Co.*, 749 F.2d 1526, 1529 (11th Cir. 1985); *United States v. McCleskey Mills, Inc.*, 409 F.2d 1216, 1219 (5th Cir. 1969); *United States v. Gleaners & Farmers Coop. Elevator Co.*, 481 F.2d 104, 105 (7th Cir. 1973); *United States v. McCleskey Mills, Inc.*, 409 F.2d 1216, 1217 (5th Cir. 1969); *United States v. Fullpail Cattle Sales*, 640 F. Supp. 976, 980 (E.D. Wis. 1986); *United States v. Smith*, 22 U.C.C. Rep. Serv. (Callaghan) 502, 509-10 (N.D. Miss. 1977); *United States v. Squires*, 378 F. Supp. 798, 800 (S.D. Iowa 1974); *United States v. Busing*, 7 U.C.C. Rep. Serv. (Callaghan) 1120, 1124 (E.D. Ill. 1970); *Get It Kwik of Am., Inc. v. First Ala. Bank*, 361 So. 2d 568, 573-74 (Ala. Civ. App. 1978); *Empire Fire & Marine Ins. Co. v. First Nat'l Bank*, 546 P.2d 1166, 1168 (Ariz. Ct. App. 1976); *People's Bank v. Pioneer Food Indus.*, 486 S.W.2d 24 (Ark. 1972); *Central Cal. Equip. Co. v. Dolk Tractor Co.*, 144 Cal. Rptr. 367, 368-69 (Cal. Ct. App. 1978); *Doenges-Glass, Inc. v. General Motors Acceptance Corp.*, 472 P.2d 761, 763 (Colo. Ct. App. 1970), *aff'd on other grounds*, 488 P.2d 879 (Colo. 1971); *Pascack Valley Bank & Trust Co. v. Ritar Ford, Inc.*, 276 A.2d 800, 806 (Conn. Cir. Ct. 1970); *Charles S. Martin Distrib. Co. v. Indon Indus.*, 213 S.E.2d 900, 902-903 (Ga. Ct. App. 1975); *Clark Jewelers v. Satterthwaite*, 662 P.2d 1301, 1304 (Kan. Ct. App. 1983); *North Cent. Kan. Prod. Credit Ass'n v. Boese*, 577 P.2d 824, 825, 827 (Kan. Ct. App. 1978); *Ranier v. Gilford*, 688 S.W.2d 753, 754 (Ky. Ct. App. 1985); *Still Assocs. v. Murphy*, 267 N.E.2d 217, 219 (Mass. 1971); *National Bank v. Frydlewicz*, 241 N.W.2d 471, 473-74 (Mich. Ct. App. 1976); *Wabasso State Bank v. Caldwell Packing Co.*, 251 N.W.2d 321, 322 (Minn. 1976); *Farmers State Bank v. Edison Non-Stock Coop. Ass'n*, 212 N.W.2d 625, 626 (Neb. 1973); *Chemical Bank v. Miller Yacht Sales*, 413 A.2d 619, 623-25 (N.J. Super. Ct. App. Div. 1980); *Lake Ontario Production Credit Ass'n of Rochester v. Partnership of Grove*, 138 A.D.2d 930, 930 (N.Y. App. Div. 1988); *Jefferson Credit Corp. v. Mid Island Auto Co.*, 5 U.C.C. Rep. Serv. (Callaghan) 423, 424 (N.Y. App. Div. 1968); *Security State Bank v. Dooley*, 604 P.2d 153, 155-56 (Okla. Ct. App. 1979); *Community Bank v. Jones*, 566 P.2d 470, 487 (Or. 1977); *Nat'l Bank v. Daniels*, 322 S.E.2d 689, 691 (S.C. Ct. App. 1984); *Trans-Nebraska Corp. v. Cummings, Inc.*,

recognized this alternative:

[W]hen a debtor makes an unauthorized disposition of collateral, the security interest, under prior law and under this Article, continues in the original collateral in the hands of the . . . transferee. That is to say, since the transferee takes subject to the security interest, the secured party may repossess the collateral from him or in an appropriate case maintain an action for conversion.¹⁰⁵

In the instant case, imagine a situation in which a debtor pays her attorney an advance fee or security retainer for an anticipated bankruptcy proceeding. Generally, whenever the debtor pays money (or anything else) to the attorney in this situation, she derives the payment from collateral, either because the payment includes property that a security agreement describes as collateral, or because the payment constitutes proceeds in which a security interest continues by force of sections 9-306(1) and (2).¹⁰⁶ The payment often is second-generation proceeds, such as money paid on an account or chattel paper that was originally the proceeds of secured inventory. Typically, the money will have traveled through the debtor's bank deposit account, which is itself proceeds, so that the ultimate payment becomes an even more remote relative of the original collateral.¹⁰⁷ In any event, the payment is collateral if the secured party can link the payment—immediately or remotely—to property in which the secured party has or had an interest.

To link the payment to collateral, the secured party must employ appropriate tracing principles. If the debtor keeps proceeds in a non-commingled account, the process is relatively simple: the secured party has a security interest in the entire account. When the debtor commingles proceeds with non-proceeds, courts employ a fictional tracing method known as the lowest intermediate balance rule,¹⁰⁸ derived from the *Restate-*

595 S.W.2d 922, 924 (Tex. Civ. App. 1980); *Production Credit Ass'n v. Nowatzski*, 280 N.W.2d 118, 122-23 (Wis. 1979); *Farm Credit Bank of St. Paul v. F & A Dairy*, 477 N.W.2d 357, 361 (Wisc. Ct. App. 1991).

105. U.C.C. § 9-306, cmt. 3 (emphasis added).

106. U.C.C. §§ 9-306(1),(2).

107. The bank account is proceeds of the money paid on receivables, and the money paid on the debtor's drafts is proceeds of the bank account, which truly is a right to payment from the bank.

108. See, e.g., *In re Chicago Lutheran Hosp. Ass'n*, 89 B.R. 719, 734 (Bankr. N.D. Ill. 1988); *In re Charter First Mortgage, Inc.*, 56 B.R. 838, 848 (Bankr. D. Oregon 1985); *Ex parte Alabama Mobile Homes, Inc.*, 468 So. 2d 156, 160 (Ala. 1985); *Central Prod. Credit Ass'n v. Hans*, 545 N.E.2d 1063, 1073 (Ill. App. Ct. 1989); *C.O. Funk & Sons, Inc. v. Sullivan Equip., Inc.*, 431 N.E.2d 370, 373 (Ill. 1982); *C & H Farm Serv. Co. v. Farmers Sav. Bank*, 449 N.W.2d 866, 877 (Iowa 1989); *Coachman Indust., Inc. v. Security Trust & Sav. Bank*, 329 N.W.2d 648,

ment (Second) of Trusts.¹⁰⁹ This rule creates a presumption that the funds, in which a legally recognized interest exists, remain on deposit for as long as possible. In other words, withdrawals are taken first from those funds in which no security interest exists and only after exhausting all these funds are withdrawals taken from the funds encumbered by a security interest.¹¹⁰

For purposes of illustration, assume that an account contains \$1,000. Of this \$1,000, approximately \$500 derives from the sale of collateral in which secured party X has a security interest (proceeds). If debtor Y withdraws \$400, a court will presume that she withdrew this amount solely from those funds in which there was no security interest. If Y withdraws another \$200, however, then the court will presume that \$100 of this withdrawal was proceeds of secured collateral.

If the secured party can use these tracing rules to link the debtor's payment to her attorney with secured collateral, the conversion analysis is straightforward. The *Restatement (Second) of Torts* defines conversion as "an intentional exercise of dominion or control over a chattel which so seriously interferes with the right of another to control it that the actor must justly be required to pay the other the full value of the chattel"¹¹¹ or the full value of the other's interest in the chattel.¹¹² In the

650 (Iowa 1983); *Universal C.I.T. Credit Corp. v. Farmers Bank*, 358 F. Supp. 317, 325-26 (E.D. Mo. 1973); *General Motors Acceptance Corp. v. Norstar Bank*, 532 N.Y.2d 685, 687 (Sup. Ct. Erie Co. N.Y. 1988); *Farmers & Merchants Nat'l Bank v. Sooner Coop., Inc.*, 766 P.2d 325, 329 (Okla. 1988).

For an informative account of the evolution of modern tracing methods under Article 9, see Richard L. Barnes, *Tracing Commingled Proceeds: The Metamorphosis of Equity Principles into U.C.C. Doctrine*, 51 U. PITT. L. REV. 281 (1990).

109. RESTATEMENT (SECOND) OF TRUSTS § 202 cmt. j (1959).

110. See, e.g., *In re Columbia Gas Systems, Inc.*, 997 F.2d 1039 (3d Cir. 1993); *First Fed. v. Barrow*, 878 F.2d 912 (6th Cir. 1989); *Connecticut Gen. Life Ins. v. Universal Ins. Co.*, 838 F.2d 612 (1st Cir. 1988).

111. RESTATEMENT (SECOND) OF TORTS § 222A(1) (1976).

112. When collateral has been converted, the secured party's recovery is usually limited to the lesser of the property's value at the time of the conversion or the value of her interest in the property. See Steve H. Nickles, *Enforcing Article 9 Security Interests Against Subordinate Buyers of Collateral*, 50 GEO. WASH. L. REV. 511, 536-39 (1982); see, e.g., *ITT Indus. Credit Co. v. H & K Mach. Serv. Co.*, 525 F. Supp. 170, 172-73 (E.D. Mo. 1981); *Mossler Acceptance Co. v. Johnson*, 109 F. Supp. 157, 181 (W.D. Ark. 1952); *Joseph Turk Mfg. Co. v. Singer Steel Co.*, 111 F. Supp. 485, 491 (N.D. Ohio 1951), *aff'd*, 202 F.2d 154 (6th Cir. 1953); *Streule v. Gulf Fin. Corp.*, 265 A.2d 298, 302 (D.C. 1970); *Hobart Mfg. Co. v. Vozeolas*, 255 A.2d 502, 504 (D.C. 1969); *Charles S. Martin Distrib. Co. v. Indon Indus.*, 213 S.E.2d 900, 902-03 (Ga. Ct. App.), *aff'd*, 218 S.E.2d 562 (Ga. 1975); *Adair v. Freeman*, 451 P.2d 519, 523 (Idaho 1969); *Clarke Floor Mach. Div. of Studebaker Corp. v. Gordon*, 7 U.C.C. Rep. Serv.

bankruptcy context, the principal elements of a conversion action, under this definition, are the secured party's right to control the collateral and the attorney-recipient's serious interference with this right. As a general rule of conversion law, an attorney-recipient in possession of a payment is liable for conversion if she "refuses without proper qualification to surrender it to another entitled to immediate possession."¹¹³ Because, under Article 9, a secured party is usually only entitled to control the collateral upon the debtor's default,¹¹⁴ an attorney-recipient cannot be liable to the secured party before the debtor defaults.¹¹⁵ Once the debtor has defaulted, however, if the at-

(Callaghan) 363, 364 (Baltimore City Super. Ct. 1970); *Brandywine Lanes, Inc. v. Pittsburgh Nat'l Bank*, 284 A.2d 802, 807 (Pa. Super. Ct. 1971); *Massey-Ferguson, Inc. v. First Nat'l Bank*, 27 U.C.C. Rep. Serv. (Callaghan) 1473, 1480 (Tenn. Ct. App. 1978); *Chrysler Credit Corp. v. Malone*, 502 S.W.2d 910, 915 (Tex. Civ. App. 1973); *Sanborn v. Brunswick Corp.*, 467 P.2d 219, 223 (Wash. Ct. App. 1970).

113. RESTATEMENT (SECOND) OF TORTS § 237 (1976).

114. "[A] secured party has on default the right to take possession of the collateral." U.C.C. § 9-503.

115. Ordinarily, a secured party may take possession of collateral only upon the debtor's default under the security agreement, *see* U.C.C. § 9-503, and may not repossess the property until this occurs, *see, e.g.*, *Brescher v. Associated Fin. Serv.*, 460 So. 2d 464, 466 (Fla. Ct. App. 1984); *Associate Discount Corp. v. Woods*, 5 U.C.C. Rep. Serv. (Callaghan) 1268, 1270 (Mass. App. 1968); *Grocers Supply Co. v. Intercity Inv. Properties*, 795 S.W.2d 225, 227 (Tx. Ct. App. 1990); *First Nat'l Bank v. Sheriff of Milwaukee County*, 149 N.W.2d 548, 549-50 (Wis. 1967); *see also* *Production Credit Ass'n v. Equity Coop. Livestock Sales Ass'n*, 261 N.W.2d 127, 129 (Wis. 1978) (holding that auctioneer exercising control over collateral is not liable for conversion if his sale of the property occurred before the debtor's default under the security agreement).

Security agreements customarily provide that the debtor's sale or other disposition of collateral is itself an event of default entitling the secured party to repossess. This, and a security agreement's other terms, are effective not only against the debtor-obligor, but also against purchasers of the collateral. *See* U.C.C. § 9-201; *see, e.g.* *United States v. Busing*, 7 U.C.C. Rep. Serv. (Callaghan) 1120, 1123 (E.D. Ill. 1970); *Legg v. Kelly*, 412 So. 2d 1202, 1207 (Ala. 1982); *Olean v. Treglia*, 463 A.2d 242, 246 (Conn. 1983); *Sturdevant v. First Sec. Bank*, 606 P.2d 525, 528 (Mont. 1980); *Poydan, Inc. v. Agia Kiriaki, Inc.*, 325 A.2d 838, 841-42 (N.J. Super. Ct. Ch. Div. 1974), *aff'd*, 354 A.2d 99 (N.J. Super. Ct. App. Div. 1976); *Brummund v. First Nat'l Bank*, 656 P.2d 884, 886 (N.M. 1983); *Redding v. Rowe*, 678 P.2d 337, 338 (Wash. Ct. App. 1984); *Production Credit Ass'n v. Nowatzski*, 280 N.W.2d 118, 122 (Wis. 1979). Often, courts impliedly recognize the enforceability of a clause in a security agreement providing that a transfer of collateral constitutes a default. *See, e.g.*, *United States v. Smith*, 22 U.C.C. Rep. Serv. (Callaghan) 502 (N.D. Miss. 1977).

Pre-Code authorities also held that a conversion action would not lie prior to the debtor's default. *See, e.g.*, *Arnold v. Sutherland*, 114 So. 140, 141 (Ala. 1927); *General Motors Acceptance Corp. v. Jones*, 106 S.E.2d 67, 68-69 (Ga. Ct. App. 1958).

In a number of pre-Code cases, courts considered whether a conditional

torney-recipient continues to retain the payment and refuses to return it, then the attorney will indeed face a conversion action.¹¹⁶ Thus, in this scenario, the attorney-recipient converts the secured party's collateral by receiving payment from such collateral and refusing to disgorge the payment because section 9-201¹¹⁷ and section 9-503¹¹⁸ entitle the secured party to possession of the property and comment 3 to section 9-306 recognizes a

vendor or chattel mortgagee could sue a tortfeasor who had damaged the collateral. Courts generally allowed such suits unless the debtor and the tortfeasor had settled or otherwise disposed of the matter. *See, e.g.,* Lowery v. Louisville & N.R.R., 153 So. 467, 468-69 (Ala. 1934); Chicago, R.I. & P. Ry. v. Earl, 181 S.W. 925, 926 (Ark. 1916); Jolly v. Thornton, 102 P.2d 467, 469 (Cal. App. Dep't Super. Ct. 1940); Lake City Auto Fin. Co. v. Waldron, 83 So. 2d 877, 878 (Fla. 1955); Ryals v. Seaboard Air-Line Ry., 123 S.E. 12 (Ga. 1924); Miller v. Hortman-Salmen Co., 145 So. 786, 789 (La. Ct. App. 1933); Motor Fin. Co. v. Noyes, 28 A.2d 235, 237 (Me. 1942); Donnell v. G.G. Deering Co., 97 A. 130, 132 (Me. 1916); Harvard Trust Co. v. Racheotes, 147 N.E.2d 817, 819 (Mass. 1958); Lacey v. Great N. Ry., 225 P. 808, 810 (Mont. 1924); Cosgriff Neon Co. v. Matthews, 371 P.2d 819, 821-23 (Nev. 1962); Stewart Motor Trucks v. New York City, 287 N.Y.S. 881, 883 (N.Y. Mun. Ct. 1936); Harris v. Seaboard Air Line Ry., 130 S.E. 319, 322 (N.C. 1925); Commercial Sec., Inc. v. Mast, 28 P.2d 635, 638 (Or. 1934); Wilkes v. Southern Ry., 67 S.E. 292, 293 (S.C. 1910); Cresbard Grain Co. v. Farnham, 244 N.W. 91, 92 (S.D. 1932); Union Ry. v. Remedial Fin. Co., 40 S.W.2d 1034, 1035 (Tenn. 1931).

Courts in pre-Code cases disagreed about whether a secured creditor had a cause of action against the tortfeasor if the damage occurred before the debtor defaulted under the mortgage or conditional sales contract. *Compare* Bell Fin. Co. v. Geffer, 147 N.E.2d 815, 816 (Mass. 1958) (holding that conditional vendor had cause of action even though vendee not in default) *and* First Nat'l Acceptance Corp. v. Annett, 2 A.2d 650, 651 (N.J. Sup. Ct. 1938), *aff'd*, 11 A.2d 106 (N.J. 1940) (same) *with* Louisville & N.R.R. v. Miller, 96 So. 322, 323-24 (Ala. 1923) (holding that conditional vendor cannot maintain trespass action against third person where purchaser is in possession and not in default) *and* Universal Credit Co. v. Collier, 31 N.E.2d 646, 648 (Ind. 1941) (same).

116. *See, e.g.,* Amarillo Nat'l Bank v. Komatsu Zeneah Am., 991 F.2d 273, 275 (5th Cir. 1993) (finding debtor's supplier liable for conversion when he did not return inventory to secured party); United States v. Edgmon, 952 F.2d 1206, 1209 (10th Cir. 1991) (affirming criminal conviction in conversion affirming father who sold son's cattle subject to FmHA security interest); Permian Petroleum Co. v. Petroleas Mexicanos, 934 F.2d 635, 651 (5th Cir. 1991); Still Assocs. v. Murphy, 267 N.E.2d 217, 218-19 (Mass. 1971); Prime Business Co. v. Drinkwater, 216 N.E.2d 105, 107 (Mass. 1966); Bankers Trust Co. v. Zecher, 426 N.Y.S. 2d 960, 964 (N.Y. Sup. Ct. 1980); Production Credit Ass'n v. Nowatzki, 280 N.W.2d 118, 122-23 (Wis. 1979); *cf.* Citizens Nat'l Bank v. Osetek, 353 F. Supp. 958, 963-64 (S.D.N.Y. 1973) (holding debtor's landlord liable for converting collateral when he seized the property and refused to return it to secured party); Hartford Fin. Corp. v. Burns, 158 Cal. Rptr. 169, 174 (Cal. Ct. App. 1979) (holding that debtor's landlord refused secured party's demand for surrender of the collateral); Chrysler Corp. v. Adamatic, Inc., 208 N.W.2d 97, 106-08 (Wis. 1973) (holding that unsecured financing buyer must return collateral to secured party or pay the property's value).

117. "[A] security agreement is effective according to its terms between the

conversion action.¹¹⁹

Significantly, conversion addresses relative rights to possession. The tort does not address issues such as a recipient's good faith and innocence or the value she provided to the debtor. The absence of these facts is not an element of the tort; nor is their presence a defense. Usually and practically, conversion is a strict liability tort based principally on whether the plaintiff or the defendant enjoys the better right to possession.¹²⁰ Thus, in

parties, against purchasers of the collateral and against creditors." U.C.C. § 9-201.

118. "[A] secured party has on default the right to take possession of the collateral." U.C.C. § 9-503.

119. See *supra* note 105 and accompanying text.

120. As noted above, conversion also requires serious interference with the other person's right to control the property. RESTATEMENT (SECOND) OF TORTS § 222A(1) (1976). This requirement is often overlooked or typically satisfied without notice. See, e.g., *Rice v. Birmingham Coal & Coke Co., Inc.*, 608 So. 2d 713, 714 (Ala. 1992) ("To constitute conversion, there must be a wrongful taking or a wrongful detention or interference, or an illegal assumption of ownership, or an illegal use or misuse of another's property." Serious interference is not an explicit requirement); *Falker v. Samperi*, 461 A.2d 681, 685 (Conn. 1983) ("The essence of [conversion] is that the property rights of the plaintiff have been dealt with in a manner adverse to him, inconsistent with his right of dominion and to his harm." No mention of serious interference); *Plikus v. Plikus*, 599 A.2d 392, 395 (Conn. App. Ct. 1991) ("Conversion occurs when one assumes and exercises the right of ownership over property belonging to another, without authorization and to the exclusion of the owner's rights." Again serious interference not an explicit requirement); *Epstein v. Automatic Enter.*, 506 A.2d 158, 160 (Conn. App. Ct. 1986) ("Conversion occurs when one, without authorization, assumes and exercises the right of ownership over property belonging to another, to the exclusion of the owner's right." No mention of serious interference); *Dairy Farm Leasing Co. v. Haas Livestock Selling Agency, Inc.*, 458 N.W.2d 417, 419 (Minn. Ct. App. 1990) ("Conversion is an act of willful interference with the personal property of another which is without justification or which is inconsistent with the rights of the person entitled to the use, possession or ownership of the property," quoting *Dain Bosworth, Inc. v. Goetze*, 374 N.W.2d 467, 471 (Minn. Ct. App. 1985). No mention of serious interference); *Jerry Harmon Motors, Inc. v. First Nat'l Bank & Trust Co.*, 472 N.W.2d 748, 754 (N. D. 1991) ("Conversion is the wrongful exercise of dominion over the personal property of another in a manner inconsistent with, or in defiance of, the owner's rights." No mention of serious interference). But see *H.J., Inc. v. International Telephone & Telegraph*, 867 F.2d 1531, 1547 (8th Cir. 1989) ("Under Minnesota law the tort of conversion is limited to willful interference with the personal property of another."); *Chemical Sales Co. v. Diamond Chem. Co.*, 766 F.2d 364, 367-68 (8th Cir. 1985) ("In order to constitute conversion any taking or use by defendant must be a serious interference with plaintiff's rights of ownership"); *Larson v. Great West Casualty Co.*, 482 N.W.2d 170, 174 (Iowa Ct. App. 1992) ("Liability may be imposed for conversion only when the intentional and wrongful interference with the property is so serious that the actor may justly be required to pay full value"); *Jordan v. Wilhelm*, 770 P.2d 74, 76 (Or. App. 1989) (holding that landlord's wrongful assertion of lien over commer-

the instant case, an attorney-recipient's good faith acceptance of a payment for services rendered or to be rendered will not constitute a defense. Nor is it a defense for the attorney-recipient to assert that she did not know of the secured party's interest or that she provided services or will provide services in exchange for the payment. The attorney-recipient is liable for conversion if she refuses to turn over property to a secured party who has a better right to possession.

B. PAYMENT OF ATTORNEYS' FEES AS A VOIDABLE PREFERENCE OR A FRAUDULENT TRANSFER

Bankruptcy law aims to distribute the bankruptcy estate to the debtor's creditors and equity holders in an order that corresponds to the prescribed hierarchy of classes of relevant claimants.¹²¹ Prior to bankruptcy, creditors often rush to collect their claims or to receive payments in order to avoid this prescribed hierarchy. This rush to payment increases the likelihood of the debtor's bankruptcy, reduces the assets available for distribution, and undermines the order and equality of distribution that are bankruptcy law's primary goals.¹²²

To prevent parties from profiting from this rush to payment, the Bankruptcy Code grants the trustee or the debtor in possession certain avoiding or avoidance powers.¹²³ These powers allow the trustee or debtor in possession to undo and recover some prebankruptcy transfers of the debtor's property and most postbankruptcy transfers of the estate's property. In turn, the trustee either distributes this recovered property to the unsecured creditors and equity holders according to the Bankruptcy Code's priority scheme or gives the property to the requisite secured party if it is secured collateral.¹²⁴ The instant case of attorneys' fees payments will likely implicate section 547¹²⁵ of the Bankruptcy Code, which allows the trustee to avoid "a transfer of the debtor's property on the eve of bankruptcy to

cial tenant's property was not conversion because the landlord's action did not so substantially interfere with tenant's rights as to support conversion).

121. 11 U.S.C. § 726 (1988).

122. 1 EPSTEIN, ET AL., BANKRUPTCY § 6-3 (1993).

123. See 11 U.S.C. §§ 544 (trustee as hypothetical lien creditor and bona fide purchaser and as successor to actual creditors); 545 (statutory liens); 546(c) (reclamation); 547(b) (preferences); 548(a) and (b) (fraudulent transfers and obligations); 549(a) (postpetition transfers); and 553(a) and (b) (set off).

124. Normally, secured parties are portrayed as avoidance victims. In the situation contemplated here, the secured party is placed in the unnatural, but not impossible, role of avoidance beneficiary.

125. See 11 U.S.C. § 547(b) (1988).

satisfy an old debt,"¹²⁶ and section 548¹²⁷ of the Bankruptcy Code, which empowers the trustee to avoid a transfer of the debtor's property, or any obligation incurred on or within one year before the filing of the bankruptcy petition.

1. Attorneys' Fees as a Voidable Preference

Under section 547(b) of the Bankruptcy Code, a trustee or debtor in possession can void a prepetition transfer that is a preference.¹²⁸ A preference is any transfer of the debtor's property on the eve or in contemplation of bankruptcy which satisfies an old debt. More formally, a preference is:

1. A transfer of an interest of the debtor in property;
2. to or for the benefit of a creditor;
3. for or on account of an antecedent debt owed by the debtor before such transfer was made;
4. made while the debtor was insolvent;
5. made on or within 90 days before the date of the filing of the petition, or within one year of the filing if the creditor is an insider; and
6. that enables the creditor to receive more than she would receive in a Chapter 7 distribution of the bankruptcy estate had the transfer not been made.¹²⁹

Section 547 strives to discourage creditors "from racing to the courthouse to dismember the debtor during his slide into bankruptcy" in order to "facilitate the primary bankruptcy policy of equality of distribution among creditors of the debtor. Any creditor that received a greater payment than others of his class is required to disgorge so that all may share equally."¹³⁰

When an attorney has received bankruptcy fees, the section 547 argument is relatively simple. Suppose, for example, that an attorney performs services for debtor X in preparation of bankruptcy and that, during this period, X's debts vastly exceed the value of her assets. Approximately one month before X files for bankruptcy, X pays the attorney \$250,000 for all services rendered over the past six months. In the ensuing bankruptcy proceeding, secured party Y receives only fifty percent of the

126. See Elizabeth A. Orelup, Note, *Avoidance of Preferential Transfers Under the Bankruptcy Reform Act of 1978*, 65 IOWA L. REV. 209, 214-15 (1979).

127. 11 U.S.C. § 548 (1988).

128. 11 U.S.C. § 547(b) (1988).

129. *Id.*

130. H.R. REP. NO. 595, 95th Cong., 1st Sess. 177-78 (1978), reprinted in 1978 U.S.C.C.A.N. 5963, 6138.

amount it is owed because debtor *X* used proceeds from the disposition of its secured collateral to pay her attorney. *X*'s general unsecured creditors, in turn, receive no more than ten percent of the amounts owed them.

The case posited satisfies all the elements of a voidable preference under section 574. *X* is a debtor.¹³¹ The \$250,000 payment was a transfer¹³² of an interest¹³³ in property belonging to the debtor,¹³⁴ and *X* transferred the money for the benefit of a creditor, her attorney.¹³⁵ *X* made the transfer on account of a debt¹³⁶ that *X* owed to the attorney before the transfer was made.¹³⁷ *X* made the transfer within 90 days before filing her

131. The term "debtor" means any person concerning whom a bankruptcy case has been commenced. 11 U.S.C. § 101(13) (1988).

132. The term "transfer" includes "every mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with property or with an interest in property . . ." 11 U.S.C. § 101(54) (1988).

133. "Interest" includes all or part of a legal or equitable claim to or right in property. Of course, if the debtor owns property jointly with another person, the preference attack is limited to the debtor's interest. *In re Van Kylan*, 98 B.R. 455, 470-72 (Bankr. W.D. Wis. 1989).

134. Bankruptcy law does not actually define "property." Courts determine the meaning by reference to state law. *See WJM Inc. v. Massachusetts Dept. of Pub. Welfare*, 840 F.2d 996, 1007 (1st Cir. 1988) ("[T]he determination whether something is an interest in property shall be made by reference to state law."); *In re Brass Kettle Restaurant*, 790 F.2d 574, 575 (7th Cir. 1986) ("We look to state law to determine whether property is an asset of a debtor."); *In re K&L Limited*, 741 F.2d 1023, 1030 n.7 (7th Cir. 1984) ("In bankruptcy proceedings federal courts will look to state law in determining whether the property is an asset of the debtor."); *In re Gladstone Glen*, 678 F.2d 1015, 1018 (7th Cir. 1980) ("[F]ederal courts will look to and follow state law in determining whether the debtor is the legal owner."); *In re Sierra Steel, Inc.*, 96 B.R. 271, 273 (Bankr. 9th Cir. 1989) ("Generally, the existence and nature of the debtor's interest in property are determined by state law. . . . State law, however, must be applied in a manner consistent with federal bankruptcy law."); *In re Kleckner*, 93 B.R. 143, 149 (Bankr. N.D. Ill. 1988) (holding that state law determines "interest of the debtor in property").

135. The term "creditor" includes any "entity that has a claim against the debtor that arose at the time of or before the order for relief concerning the debtor." 11 U.S.C. § 101(10)(A) (1988). "Claim" includes "any right to payment." 11 U.S.C. § 101(5)(A) (1988).

136. "[D]ebt means liability on a claim." 11 U.S.C. § 101(12) (1988). Because "[t]he terms creditor and debt are . . . statutorily congruent," *In re Cohen*, 875 F.2d 508, 510 (5th Cir. 1989), whenever there is a transfer to a creditor for or on account of the creditor's claim against the debtor, there is likewise a transfer for or on account of a debt that the debtor owed.

137. *See In re Wey*, 78 B.R. 892, 895 (C.D. Ill. 1987) ("[A] debt is contracted when a debtor becomes legally obligated to pay."), *aff'd*, 854 F.2d 196 (7th Cir. 1988); *In re Miniscribe Corp.*, 123 B.R. 86, 90 (Bankr. D. Colo. 1991) ("[A] debt is antecedent if it is incurred before the transfer"); *In re Lamons*, 121 B.R. 748, 750-51 (Bankr. S.D. Ohio 1990) (holding that an "[a]ntecedent debt" includes a debt incurred before the transfer, and a debt is incurred when the debtor be-

bankruptcy petition¹³⁸ and was insolvent when she made the payments, inasmuch as her liabilities exceeded her assets.¹³⁹ Finally, the transfer had a preferential effect because it enabled the attorney to receive more than she would have received in a Chapter 7 case.¹⁴⁰ In a Chapter 7 case, the attorney would have

comes legally obligated to pay); *In re Cavalier Homes, Inc.*, 102 B.R. 878, 887 (Bankr. M.D. Ga. 1989) (stating that an antecedent debt means debt that was owed before the transfers were made); *In re Fonda Group, Inc.*, 108 B.R. 956, 959 (Bankr. D.N.J. 1989) ("[A] debt is 'antecedent' when the debtor becomes legally bound to pay before the transfer is made."); *In re Almarc Mfg.*, 52 B.R. 582, 585 (Bankr. N.D. Ill. 1985) ("Most courts . . . have held that a debt is incurred for purposes of § 547(c)(2) when the debtor becomes legally obligated to pay. . . . The legal obligation to pay arises either on shipment or delivery, depending on the contractual agreement."); *In re Western World Funding*, 54 B.R. 470, 476 (Bankr. D. Nev. 1985) ("[A]ntecedent debt may be described as preexisting or prior debt, so as to preclude the avoidance of a transfer made simultaneous with or prior to the extension of credit or transfer of value to the debtor.").

138. A transfer that occurs after this period is immune from attack as a preference, *see, e.g., In re Ford Concepts, Inc.*, 85 B.R. 893, 896 (Bankr. S.D. Fla. 1988); *In re Sims Office Supply, Inc.*, 94 B.R. 744, 747 (Bankr. M.D. Fla. 1988), but is nevertheless vulnerable under § 549 which governs the validity of postpetition transfers. *See* 11 U.S.C. § 549 (1988).

139. Insolvency exists under the Bankruptcy Code when the sum of debts exceeds the fair market valuation of all property. 11 U.S.C. § 101(32)(A) (1988). In other words, the Bankruptcy Code uses a "balance sheet" test to determine insolvency. *See In re Taxman Clothing Co., Inc.*, 905 F.2d 166, 169-70 (7th Cir. 1990); *In re Koubourlis*, 869 F.2d 1319, 1321 (9th Cir. 1989); *In re Sierra Steel, Inc.*, 96 B.R. 275, 277 (Bankr. 9th Cir. 1989); *In re Writing Sales Ltd. Partnership*, 96 B.R. 175, 177 (Bankr. E.D. Wis. 1989). The debtor is insolvent when its liabilities exceed its assets at a fair valuation. *In re Joe Flynn Rare Coins, Inc.*, 81 B.R. 1009, 1017 (Bankr. D. Kan. 1988); *accord, Briden v. Foley*, 776 F.2d 379 (1st Cir. 1985); *In re Excelllo Press, Inc.*, 96 B.R. 840, 842 (Bankr. N.D. Ill. 1989); *In re Plihal*, 97 B.R. 554, 557-58 (Bankr. D. Neb. 1989); *In re Writing Sales Ltd. Partnership*, 96 B.R. 175, 177 (Bankr. E.D. Wis. 1989); *In re F.H.L., Inc.*, 91 B.R. 288, 293 (Bankr. D.N.J. 1988); *In re Rose*, 86 B.R. 193, 194 (Bankr. W.D. Mo. 1988). Courts have not developed a set, rigid approach to determining "fair valuation" and accomplish the task in various ways. *Porter v. Yukon Nat'l Bank*, 866 F.2d 355, 356-57 (10th Cir. 1989).

140. The exclusive focus, for purposes of the comparison, is the amount of the Chapter 7 distribution to the creditor. Courts consider nothing else. As one court opined:

Plainly enough, this language [of section 547(b)(5)] is intended to focus the Court's attention on the distribution that the creditor would have received (assuming the transfer had not been made) as a result of the due administration of the debtor's estate pursuant to the Bankruptcy Code, according to the priorities of distribution set forth in sections 507 and 726.

In re Finn, 86 B.R. 902, 904 (Bankr. E.D. Mich. 1988), *order aff'd*, 111 B.R. 123 (Bankr. E.D. Mich. 1989), *rev'd on other grounds*, 909 F.2d 903 (6th Cir. 1990) (disregarding the reaffirmation agreement between the defendant-creditor and the debtor).

To determine whether a transfer created a preferential effect, a purely "hy-

pothectical [Chapter 7] liquidation case must be created to determine if the creditor's position was improved by the transfer." Charles J. Young, *Preference Under the Bankruptcy Reform Act of 1978*, 54 AM. BANKR. L.J. 221, 224 (1980). The date of the imaginary case, as well as the date of the imaginary liquidation and distribution, is the day on which the debtor filed her petition in the actual bankruptcy case. Courts ignore actual postpetition developments and have repeatedly said:

[T]he analysis required by section 547(b)(5) must be undertaken as of the moment of bankruptcy, and not some later, unspecified date. . . . Section 547(b)(5) codifies the Supreme Court's holding in *Palmer Clay Products Co. v. Brown* [297 U.S. 227, 229, 56 S. Ct. 450, 450-51, 80 L. Ed. 655 (1936)]: whether a particular transfer is preferential should be determined 'not by what the situation would have been if the debtor's assets had been liquidated and distributed among his creditors at the time the alleged preferential payment was made, but by the actual effect of the payment as determined when bankruptcy results.'

In re Finn, 86 B.R. at 904-05; see also *In re Tenna Corp.*, 801 F.2d 819, 821-24 (6th Cir. 1986) (holding that the proper date when the hypothetical liquidation must be made is the date the debtor filed her bankruptcy petition, excluding real postpetition debt incurred during an actual reorganization); *In re Buyer's Club Mkts., Inc.*, 123 B.R. 895, 896-97 (Bankr. D. Colo. 1991) (deciding that the day to apply in a § 547(d)(5) dispute is the day of the filing of the petition); *In re Omni Mechanical Contractors, Inc.*, 114 B.R. 518, 534 (Bankr. E.D. Tenn. 1990) ("[T]he § 546(b)(5) evaluation is to be made as of the time the debtor originally filed its bankruptcy petition."); *In re Ludford Fruit Prod., Inc.*, 99 B.R. 18, 24 (Bankr. C.D. Cal. 1989) ("Trustee must look to the date of the filing of the bankruptcy petition to construct a hypothetical Chapter 7 liquidation for purposes of Section 547(b)(5)."); *In re Hobaica*, 77 B.R. 392, 394-95 (Bankr. N.D.N.Y. 1987) (holding that trustee must look to filing date to construct hypothetical liquidation); *In re Meinhardt Mechanical Serv. Co.*, 72 B.R. 548, 551 (Bankr. W.D. Pa. 1987) (considering the distribution that would have been made on the date of the filing of the bankruptcy petition); *In re Independent Clearing House Co.*, 41 B.R. 985, 1013 (Bankr. D. Utah 1984) ("Whether a creditor has received a preference is to be determined . . . by the actual effect of the payment as determined when bankruptcy results."); *In re Zachman Homes*, 40 B.R. 171, 172 (Bankr. D. Minn. 1984) (using legislative history and case law, court determined the comparison to be against what the debtor would have received the day the bankruptcy petition was filed); *In re Tonyan Const. Co.*, 28 B.R. 714, 723 (Bankr. N.D. Ill. 1983) (looking at a hypothetical liquidation on date petition was filed to determine preferences).

This Chapter 7 liquidation must be imagined even if the debtor has actually filed for Chapter 11 reorganization or for relief under another chapter of the Bankruptcy Code.

[I]n any Chapter 11 proceeding a hypothetical liquidation must be done. . . . [T]his analysis must also be made in rehabilitative proceedings under Chapter 13, and, of course, in Chapter 7 proceedings. In any of these proceedings, the bankruptcy court does not liquidate the assets when making the § 547(b) determination, it determines the priority status of all creditors as 'if the Chapter 7 liquidation had been made.'

In re Tenna Corp., 801 F.2d 819, 821 (6th Cir. 1986); see also *In re Virtual Network Serv. Corp.*, 92 B.R. 784, 785-86 (Bankr. N.D. Ill. 1988) ("In a Chapter 11 case, a hypothetical liquidation of the debtor's estate must be done to determine whether a payment is preferential.").

received only ten percent of what *X* owed her, or \$25,000. Here, in contrast, she received full payment. Thus, unless the attorney can establish that the payment falls within a section 547(c) exception to section 547(b),¹⁴¹ the payment is voidable and recoverable under section 550(a).¹⁴²

2. Attorneys' Fees as a Fraudulent Transfer

Section 548 is also potentially significant in the attorneys' fees context. To evade creditor efforts to seize their assets, debtors sometimes transfer their property to friends or relatives for little or no consideration with the understanding that the debtor will continue to have the use and benefit of the property. The Statute of Elizabeth 13, chapter 5,¹⁴³ which Parliament enacted in 1570, first addressed this problem by condemning any conveyance of property made with the intent "to delay, hinder or defraud creditors."¹⁴⁴

Until 1918, American jurisdictions either recognized the Statute of Elizabeth as part of their inherited common law or enacted identical or very similar versions of it. In 1918, however, a new model law was promulgated, and subsequently adopted in many jurisdictions, the Uniform Fraudulent Conveyance Act (UFCA).¹⁴⁵ Even more recently, in 1984, the National Conference of Commissioners on Uniform State Laws promulgated a successor to the UFCA, the Uniform Fraudulent Trans-

141. The exceptions under § 547(c) are commonly known as:

- 1) the contemporaneous new value exception;
- 2) the ordinary payment of ordinary debts exception;
- 3) the purchase money security interest exception;
- 4) the subsequent new value exception;
- 5) the floating liens on inventory or receivables exception;
- 6) the statutory liens exception; and
- 7) the small transfers in consumer cases exception.

See 11 U.S.C. § 547(c) (1988); see generally 1 EPSTEIN ET AL., *supra* note 122, §§ 6-23 to 6-37, at 315-58 (explaining requirements of exceptions § 547(c)).

142. "[T]o the extent that a transfer is avoided under section . . . 547 . . . the trustee may recover, for the benefit of the estate, the property transferred, or, if the court so orders, the value of such property . . ." 11 U.S.C. § 550(a) (1988).

143. 13 Eliz., ch. 5 (1570) (Eng.).

144. *Id.*; see, e.g., *In re Jeffrey Bigelow Design Group*, 956 F.2d 479, 483-84 (4th Cir. 1992); *In re Electronic Metal Prods., Inc.*, 916 F.2d 1502, 1505 (10th Cir. 1990).

145. See, e.g., *In re MortgageAmerica Corp.*, 714 F.2d 1266 (5th Cir. 1983); *In re Fashion Optical, Ltd.*, 653 F.2d 1385 (10th Cir. 1981) (Oklahoma legislature adopted UFCA); *C.E.H. McDonnell v. American Leduc Petroleum, Ltd.*, 456 F.2d 1170, 1178 (2d Cir. 1972) (New York and California enacting UFCA without change); *In re Dee's, Inc.*, 311 F.2d 619, 621 (3d Cir. 1962) (UFCA in force in Pennsylvania).

fers Act (UFTA).¹⁴⁶ Like the Statute of Elizabeth 13, both the UFCA and the UFTA condemn transfers that are actually fraudulent, those the debtor made with an intent to defraud.¹⁴⁷ Additionally, both Acts also condemn constructively fraudulent conveyances. They condemn transfers of the debtor's property irrespective of the debtor's intent if the court deems such transfers to be unfair to the debtor's creditors.

Bankruptcy Code section 548 contains provisions similar to these two state Acts. Under section 548, a trustee can avoid a fraudulent transfer¹⁴⁸ of the debtor's property, or any obligation

146. See, e.g., *Hayes v. FP&I Nursery Partners* 1984-I, 936 F.2d 577 (9th Cir. 1993) (Hawaii codified the UFTA); *In re Comm'l Acceptance Corp.*, 5 F.3d 535 (9th Cir. 1993) (California adopted the UFTA); *United States v. Amistad*, No. CIV.90-0265-S-WBS, 1993 WL 370838, at *5 (D. Idaho May 13, 1993) (Case governed by Idaho version of UFTA); *In re Young*, 148 B.R. 886, 892 n.9 (Bankr. D. Minn. 1992), *order aff'd*, 152 B.R. 939 (D. Minn. 1993) ("The UFTA is the successor to the UFCA" and has been adopted in Minnesota).

147. *United States v. Tabor Court Realty Corp.*, 803 F.2d 1288, 1304 (3d Cir. 1986) (conveyance made with intent to defraud is fraudulent under UFTA); *In re Fashion Optical, Ltd.*, 653 F.2d 1385, 1387 (10th Cir. 1981) (UFCA prohibits conveyances made with intent to defraud); *Amalgamated Bank of New York v. Marsh*, 823 F. Supp. 209, 216 (S.D.N.Y. 1993) (intent to defraud prohibited under UFTA); *Godina v. Oswald*, 211 A.2d 91, 93 (Pa. Super. Ct. 1965) (conveyance made with intent is fraudulent under UFCA).

148. As a practical matter, "transfer" means any event that results in eliminating or diluting the debtor's interest in property. For purposes of section 548, the term includes not only a sale, gift or other absolute, voluntary conveyance of the debtor's interest in property, but various other dispositions as well. See *In re Russell*, 927 F.2d 413 (8th Cir. 1991) (debtor-taxpayer's election under tax laws to carry forward net operating losses); *In re Universal Clearing House Co.*, 62 B.E. 118 (D. Utah 1986) (paying money to victim of "Ponzi" scheme that debtor operated), *aff'd in part, rev'd in part*, 62 B.R. 118 (D. Utah 1986); *In re Hooton*, 48 B.R. 575 (N.D. Ala. 1985) (formalization of judgment that creates a lien); *In re Christian*, 48 B.R. 833 (D. Colo. 1985) (mortgage foreclosure); *In re Stratton*, 23 B.R. 284 (D.S.D. 1982) (execution and delivery of second mortgage on homestead); *In re Indri*, 126 B.R. 443 (Bankr. D.N.J. 1991) (termination of a lease or other executory contract); *In re Stevens*, 112 B.R. 175 (Bankr. S.D. Text 1989) (renunciation of an inheritance); *In re Thrifty Dutchman, Inc.*, 97 B.R. 101, 105-08 (Bankr. S.D. Fla. 1988) (state court judgment reinstating expired lease of real property and requiring debtor-landlord to surrender certain rights therein); *In re Sure-Snap Corp.*, 88 B.R. 449 (Bankr. S.D. Fla. 1988) (substituting for the debtor the name of someone else as beneficiary of life insurance); *In re Edward Harvey Co., Inc.*, 68 B.R. 851 (Bankr. D. Mass. 1987) (lease termination); *In re Main*, 75 B.R. 322 (Bankr. D. Ariz. 1987) (deed in lieu of foreclosure); *In re Ottaviano*, 63 B.R. 338 (Bankr. D. Conn. 1986) (filing of lis pendens); *In re Bell & Beckwith*, 64 B.R. 620 (Bankr. N.D. Ohio 1986) (transfer of right to possession); *In re Venice Western Motel, Ltd.*, 67 B.R. 777 (Bankr. M.D. Fla. 1986) (restructuring secured debt to increase the principal obligation and thereby reduce the debtor's equity in the collateral); *In re Wallace*, 66 B.R. 834 (Bankr. E.D. Mo. 1986) (divorce decree that disposes of debtor's interest in property as tenant by the entirety); *In re Factory Tire Distributors, Inc.*, 64 B.R.

the debtor fraudulently made or incurred¹⁴⁹ within one year

335 (Bankr. W.D. Pa. 1986) (consignment); *In re Louis L. Lasser & Stanley M. Kahn*, 68 B.R. 492 (Bankr. E.D.N.Y. 1986) (tax sale); *In re Zeman*, 60 B.R. 764 (Bankr. N.D. Iowa 1986) (quitclaim deed); *In re Piche*, 55 B.R. 339 (Bankr. S.D. Fla. 1985) (transfer of real property to corporation); *In re Queen City Grain, Inc.*, 51 B.R. 722 (Bankr. S.D. Ohio 1985) (lease termination); *In re W.E. Tucker Oil, Inc.*, 42 B.R. 897 (Bankr. W.D. Ark. 1984) (granting lien on property); *In re Fashion World, Inc.*, 44 B.R. 754 (Bankr. D. Mass. 1984) (modification of lease that gave lessor right to terminate); *In re Jermoo's Inc.*, 38 B.R. 197 (Bankr. W.D. Wis. 1984) (termination of debtor's franchise dealerships); *In re Moore*, 39 B.R. 571 (Bankr. M.D. Fla. 1984) (paying money to victims of debtor's "ponzi" scheme); *In re Jones*, 68 B.R. 483 (Bankr. W.D. Mo. 1984) (transfer of debtor's interest as vendee under contract for deed). With respect to renouncing or disclaiming a testamentary gift, as in *Stevens*, there is a different view. See *In re Atchison*, 925 F.2d 209 (7th Cir. 1991), *cert. denied*, — U.S. —, 112 S. Ct. 178, 116 L. Ed. 2d 140 (1991) (a beneficiary's disclaimer that is governed by Illinois law is not a transfer for purposes of § 548).

149. A transfer of property may affect the debtor, or be accomplished by her, but nevertheless be beyond the scope of section 548 because the debtor had no interest in the subject property. See, e.g., *In re Chase & Sanborn Corp.*, 813 F.2d 1177, 1181-82 (11th Cir. 1987) (transfer of funds placed in debtor's account by third party); *In re N & D Properties, Inc.*, 799 F.2d 726, 733-34 (11th Cir. 1986) (pledge of third party's stock for debtor's obligations); *Kupetz v. Continental Illinois Nat'l Bank & Trust Co.*, 77 B.R. 754, 764 (C.D. Cal. 1987), *aff'd*, 845 F.2d 842 (9th Cir. 1988) (issuer's payment of letter of credit); *In re Jackson*, 105 B.R. 15 (Bankr. S.D. Ohio 1989) (debtor's forfeiture of ring to pawn shop was not fraudulent or preferential because debtor had no interest in the property); *In re Peebles*, 105 B.R. 90, 95 (Bankr. M.D. Fla. 1989) (property transferred by debtor and wife could not be attacked as fraudulent because the property held by the entireties and thus debtor had no individual interest therein); *In re Manufacturers Acceptance Corp.*, 86 B.R. 729 (Bankr. S.D. Fla. 1988) (offset of reserve account established by debtor); *In re Duque Rodriguez*, 77 B.R. 942, 944 (Bankr. S.D. Fla. 1987) (debtor conveyed third person's funds); *In re Rosenberg*, 69 B.R. 3 (Bankr. E.D.N.Y. 1986) (transfer of property held in trust); *In re Alston*, 49 B.R. 929, 932 (Bankr. E.D.N.Y. 1985) (payments of debtor's wages by employer in response to garnishment); *In re Originala Petroleum Corp.*, 39 B.R. 1003, 1014-15 (Bankr. N.D. Tex. 1984) (letter of credit and its proceeds are property of the issuer rather than the debtor).

State law determines whether the debtor had an interest in the transferred property. *In re Universal Clearing House Co.*, 62 B.R. 118, 130 (D. Utah 1986); *In re Ipswich Bituminous Concrete Prods., Inc.*, 82 B.R. 661 (Bankr. D. Mass. 1988).

The required transfer of the debtor's property is met even if the debtor held only bare legal title. A particular transfer, however, may not satisfy section 548 for some other reason. For example, in *In re Gillman*, 120 B.R. 219 (Bankr. M.D. Fla. 1990), the debtor transferred to his mother, for no value, his interest in property they held as joint tenants. *Id.* at 220. The debtor owned no beneficial interest. This transfer was attacked as constructively fraudulent under section 548(a)(2), which requires the absence of reasonably equivalent value for the transfer. *Id.* The transfer survived the attack because the court decided that the debtor's interest, which was bare legal title, was worthless. *Id.* at 220. The technical explanation is probably that the debtor received reasonably equivalent value: nothing for nothing.

prior to filing the bankruptcy petition.¹⁵⁰ Under section 548 a fraudulent transfer occurs when the debtor acted "with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date such transfer was made or such obligation incurred, indebted."¹⁵¹

Direct evidence of the requisite intent is rarely available. Thus, it would seem that the trustee could almost never avoid a transfer under section 548(a)(1) because she bears the burden of proving actually fraudulent intent.¹⁵² Two favorable evidentiary twists, however, significantly lighten the trustee's burden. First, the trustee need not provide direct evidence of actual fraudulent intent. Circumstantial evidence, in the form of badges of fraud, will suffice.¹⁵³ In addition, the occurrence of

150. 11 U.S.C.A. § 548(a) (1988); *In re Major Funding Corp.*, 126 B.R. 504, 507-08 (Bankr. S. D. Tex. 1990) (Transfers more than one year before filing are beyond the scope of the trustee's powers under § 548.); *In re Sun Spas by Schaeffer, Inc.*, 122 B.R. 452, 454 (Bankr. M.D. Fla. 1990) ("Plaintiff in this case has submitted evidence indicating that there was substantial misconduct in the business affairs of the debtor. However, she has not proven that such misconduct occurred within the prescribed one year time limit. This mandatory element of § 548(a) is clear and unmistakable."). This rule puts beyond the reach of section 548 not only transfers that occurred more than one year before the bankruptcy petition, but also transfers that occurred after the debtor filed the petition. In other words, post-petition transfers are not subject to avoidance under section 548. See e.g., *In re Ford Concepts, Inc.*, 85 B.R. 893, 897 (Bankr. S.D. Fla. 1988); *In re Meltzer*, 84 B.R. 312, 314 (Bankr. D. Conn. 1988), *appeal denied*, 90 B.R. 21 (D. Conn. 1988); *In re Matheson*, 84 B.R. 435, 436 (Bankr. N.D. Tex. 1987); *In re Fisher*, 80 B.R. 58, 61 (Bankr. M.D.N.C. 1987); *In re Nemeti*, 65 B.R. 391, 395 (Bankr. N.D.N.Y. 1986); *In re Earl Roggenbuck Farms, Inc.*, 51 B.R. 913, 921-22 (Bankr. E.D. Mich. 1985); *In re Bluford*, 40 B.R. 640, 644 (Bankr. W.D. Mo. 1984).

When a case is converted from a Chapter 11 reorganization to a Chapter 7 liquidation, the critical date is the filing of the original Chapter 11 petition rather than the date of conversion. See generally *Hoffman v. Cheek*, 90 B.R. 21, 24 (D. Conn. 1988).

151. 11 U.S.C. § 548(a)(1) (1988).

152. See, e.g., *In re Simmons*, 124 B.R. 606, 608 (Bankr. M.D. Fla. 1991); *In re Pinto Trucking Serv., Inc.*, 93 B.R. 379, 385 (Bankr. E.D. Pa. 1988); *In re Reininger-Bone*, 79 B.R. 53, 55 (Bankr. M.D. Fla. 1987); *In re BGNX, Inc.*, 75 B.R. 44, 46 (Bankr. S.D. Fla. 1987); *In re Missionary Baptist Found. of Am.*, 24 B.R. 973 977 (Bankr. N.D. Tex. 1982); *In re Thames*, 21 B.R. 704, 706 (Bankr. D.S.C. 1981).

153. *In re Bridge*, 90 B.R. 839, 845 (Bankr. E.D. Mich. 1988), *on reh'g*, 106 B.R. 474 (Bankr. E.D. Mich. 1989); see also *Max Sugarman Funeral Home, Inc. v. A.D.B. Investors*, 926 F.2d 1248, 1254 (1st Cir. 1991) ("It is often impracticable, on direct evidence, to demonstrate an actual intent to hinder, delay or defraud creditors. Therefore, as is the case under the common law of fraudulent conveyance, courts applying Bankruptcy Code § 548(a)(1) frequently infer fraudulent intent from the circumstances surrounding the transfer, taking particular note of certain recognized indicia or badges of fraud."); *In re Major Fund-*

certain combinations of these badges of fraud creates a presumption of fraudulent intent, shifting the burden of proof to the transferee to establish the lack of such intent.¹⁵⁴

Alternatively, a transfer is constructively fraudulent when the debtor made the transfer for less than "reasonably equivalent value"¹⁵⁵ and the debtor was or thereby became in-

ing Corp., 126 B.R. 504, 508 (Bankr. S.D. Tex. 1990) ("Due to the difficulty in proving intent to defraud, it may be implied from circumstances surrounding the transaction. . . . A finding of requisite intent to make a fraudulent conveyance may be predicated upon a concurrence of facts which, while not direct evidence of actual intent, lead to the irresistible conclusion that the transferor's conduct was motivated by such intent."); *In re Damo Corp.*, 101 B.R. 810, 812 (Bankr. S.D. Fla. 1989) (but finding no actual fraud); *In re Osbourne*, 124 B.R. 726, 728 (Bankr. W.D. Ky. 1989) ("Fraudulent intent however is rarely susceptible to direct proof. Therefore the courts have developed circumstances or 'badges of fraud' to establish the requisite intent. . . . A combination of the . . . [badges] generally provides reasonable grounds to find the transfer was made with actual intent to hinder, delay or defraud creditors.") (citation omitted)).

154. In discussing the effect of this presumption, the courts usually refer, very generally, to shifting the "burden of proof" without specifying whether they mean the burden of persuasion or only the burden of going forward with the evidence. *See, e.g., In re Major Funding Corp.*, 126 B.R. 504, 508 (Bankr. S.D. Tex. 1990); *In re Reininger-Bone*, 79 B.R. 53, 55 (Bankr. M.D. Fla. 1987); *In re Stevenson*, 69 B.R. 49, 50 (Bankr. E.D. Mo. 1986); *In re Porter*, 37 B.R. 56, 61 (Bankr. E.D. Va. 1984). At the same time, the courts equate the presumption with establishing a prima facie case for the trustee. This equation implies that the presumption shifts only the burden of going forward with the evidence. *In re Camden Nursery, Inc.*, 31 B.R. 1, 4 (Bankr. D.S.C. 1982) (burden of going forward rather than burden of persuasion shifts to defendant when trustee makes prima facie case by evidence of badges of fraud).

In any event, the presumption is rebuttable so that the presence of facts giving rise to the presumption does not in itself entitle the trustee to summary disposition. *In re Shelton*, 33 B.R. 377 (M.D. Tenn. 1983).

155. In deciding whether something that the debtor received in exchange for a transfer is "reasonably equivalent value," the court must determine whether the debtor received "value" and, if so, how the value received compared to the property that she transferred or the obligation she incurred in exchange therefor.

Section 548 defines "value" to mean, "property, or satisfaction or securing of a present or antecedent debt of the debtor, but does not include an unperformed promise to furnish support to the debtor or to a relative of the debtor." 11 U.S.C. § 548(d)(2)(A) (1988).

A debtor most obviously receives value when she transfers her property, absolutely or as security, in contemporaneous exchange for goods, real estate, a loan of money, or other property. *See, e.g., Johnson v. First Nat'l Bank*, 81 B.R. 87 (Bankr. N.D. Fla. 1987) (securing a debt constitutes value); *Hartley v. Peoples Bankr Co.*, (*In re Hartley*), 52 B.R. 679 (Bankr. N.D. Ohio 1985) (same); *Willson Dairy Co. v. Burchett* (*In re Willson Dairy Co.*), 30 B.R. 67 (Bankr. S.D. Ohio 1983) (same); *Hemphill v. T & F Land Co.*, (*In re Hemphill*), 18 B.R. 38 (Bankr. S.D. Iowa 1982) (same).

The meaning of value is not so limited, however. Value also includes both paying or securing a preexisting debt. 11 U.S.C. § 548(d)(2)(A); *see United En-*

solvent;¹⁵⁶ was engaged in business with unreasonably small

ergy Corp. v. C.H. Rider & Family (*In re United Energy Corp.*), 944 F.2d 589, 595-96 (9th Cir. 1991) (holding that potential claims for rescission and restitution, and payments made in the course of a Ponzi scheme were value); *RIS v. Soc'y for Savs.* (*In re Countdown of Conn. Inc.*), 115 B.R. 18, 21-22 (Bankr. D. Conn. 1990) (securing antecedent debt is value); *In re Cavalier Homes, Inc.*, 102 B.R. 878, 885-86 (Bankr. M.D. Ga. 1989) (satisfying preexisting contingent liability as guarantor was value); *Pereira v. Hope* (*In re 500 Les Mouches Fashions, Ltd.*), 24 B.R. 509, 516 (Bankr. S.D.N.Y. 1982) (securing antecedent debt is value); *Butz v. Pingel* (*In re Pingel*), 17 B.R. 236, 238 (Bankr. S.D. Ohio 1982)(same).

Thus the concept of value is broader than common-law consideration. See RESTATEMENT (SECOND) OF CONTRACTS § 73 (1981) (performance of legal duty not consideration). Even satisfying an antecedent debt is value. See, e.g., *In re N & D Properties, Inc.*, 54 B.R. 590, 605 (N.D. Ga. 1985) (finding payment of interest on loan is for antecedent debt and thus is value), *aff'd in part, rev'd in part*, 799 F.2d 726 (11th Cir. 1986); *Sorenson v. Tire Holdings, Ltd.* (*In re Vinzant*), 108 B.R. 752, 759 (Bankr. D. Kan. 1989) (holding transfer of assets in satisfaction or forgiveness of antecedent debt is value); *Pinetree Partners v. OTR* (*In re Pinetree Partners*, 87 B.R. 481, 492 (Bankr. N.D. Ohio 1988) (finding antecedent debt is value); *Wilson v. TXO Prod. Corp.* (*In re Wilson*), 69 B.R. 960, 964 (Bankr. N.D. Tex. 1987) (withholding antecedent royalty payments pursuant to operator's lien is value); *Stenberg v. Johnson* (*In re Edward M. Johnson & Associates, Inc.*), 61 B.R. 801, 807-08 (Bankr. E.D. Tenn. 1986) (holding transfer of property in exchange for forgiving loan obligation is value); *Alston v. Grandee Beer Distribs., Inc.* (*In re Alston*), 49 B.R. 929, 933 (Bankr. E.D.N.Y. 1985) (holding that payments by debtor pursuant to post-judgment execution are for antecedent debt and thus constitute value); *Freehling v. Garson* (*In re Top Sport Distrib., Inc.*), 41 B.R. 235, 239 (Bankr. S.D. Fla. 1984) (holding repayment of secured loan, including interest, is for reasonably equivalent value); *United States v. Beattie* (*In re Beattie*), 31 B.R. 703, 715 (Bankr. W.D.N.C. 1983) (applying proceeds of collateral to secured debt, i.e., enforcing lien rights is value); *Huddleston v. Castle* (*In re Stewart*), 21 B.R. 329, 331 (Bankr. E.D. Tenn. 1982) (satisfying preexisting debt is value); *Campbell v. Thames* (*In re Thames*), 21 B.R. 704, 707 (Bankr. D.S.C. 1981) (transferring legal interest in property to person who is already the beneficial owner is value).

It should be noted that even payment toward an antecedent debt which does not fully satisfy the debt nevertheless constitutes reasonably equivalent value. As one court noted, "It would be unreasonable . . . to interpret the word 'satisfaction' [in the definition of value] to mean only a satisfaction of the entire debt." *Jones v. Cedar Bluff Bank* (*In re Crane*), 6 B.R. 7, 8 (Bankr. N.D. Ala. 1980); see, e.g., *RIS v. Society for Savs.* (*In re Countdown of Conn., Inc.*), 115 B.R. 18, 21-22 (Bankr. D. Conn. 1990); *In re Vescovo*, 125 B.R. 468, 473 (Bankr. W.D. Tex. 1990); *Iannawne v. Capital City Bank* (*In re Richards*), 58 B.R. 233, 237-38 (Bankr. D. Minn. 1986); *In re Ward*, 36 B.R. 794, 799 (Bankr. D.S.D. 1984); *Abraham v. Central Trust Co.* (*In re Abraham*), 33 B.R. 963, 967-68 (Bankr. M.D. Fla. 1983); *Lucas v. Fayette* (*In re Lucas*), 21 B.R. 794, 799-800 (Bankr. W.D. Mich. 1982). It makes no difference that the debtor received nothing new, in terms of property added to her estate, at the time of the transfer.

156. 11 U.S.C. § 548(a)(2)(B)(i) (1988) ("insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation").

capital;¹⁵⁷ or intended to incur debts that would exceed her ability to pay.¹⁵⁸ The trustee challenging a transfer as constructively fraudulent under section 548(a)(2) bears the burden of proof on all of the necessary elements, including the debtor's insolvency and the inequivalency of value.¹⁵⁹ The trustee need only establish these elements by a preponderance of the evidence, however, instead of by the "clear and convincing" standard applied when the trustee alleges actual fraud.¹⁶⁰ Moreover, the burden of production may shift to the defendant

157. 11 U.S.C. § 548(a)(2)(A)(B)(ii) (1988) ("was engaged in business or a transaction, or was about to engage in business or a transaction, for which any property remaining with the debtor was an unreasonably small capital").

158. 11 U.S.C. § 548(a)(2)(A)(B)(iii) (1988) ("intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured").

159. See, e.g., *Wordberg v. Arab Banking Corp.* (*In re Chase & Sanborn Corp.*), 904 F.2d 588, 593-94 (11th Cir. 1990) ("The burden of proving lack of 'reasonably equivalent value' . . . rests on the trustee challenging the transfer."); *Cooper v. Ashley Communications, Inc.*, 914 F.2d 458, 466 (4th Cir. 1990) (stating trustee bears burden of proving each of the statutory elements of fraudulent transfer); *Schaps v. Just Enough Corp.* (*In re Pinto Trucking Serv., Inc.*), 93 B.R. 379, 388 (Bankr. E.D. Pa. 1988) (holding that trustee has burden on equivalent value); *Ohio Corrugating Co. v. DPAC, Inc.* (*In re Ohio Corrugating Co.*), 91 B.R. 430, 435 (Bankr. N.D. Ohio 1988) (providing that burden of proof on constructive fraud rests on party alleging the avoidable transfer); *Pinetree Partners v. OTR* (*In re Pinetree Partners, Ltd.*), 87 B.R. 481, 492 (Bankr. N.D. Ohio 1988) (debtor in possession has burden on all elements under § 548); *Bailey v. Metzger, Shadyac & Schwarz* (*In re Butcher*), 72 B.R. 447, 449 (Bankr. E.D. Tenn. 1987) (holding trustee has burden of proof); *Coors, Inc. v. Bank of Longview* (*In re Coors, Inc.*), 66 B.R. 845, 861 (Bankr. N.D. Miss. 1986) (holding debtor in possession has the burden of proving a fraudulent transfer or obligation); *Ellenberg v. Chapel Hill Harvester Church, Inc.* (*In re Moses*), 59 B.R. 815, 817-18 (Bankr. N.D. Ga. 1986) (stating burden of proving constructive fraud on trustee); *In re Ristich*, 57 B.R. 568, 578 (Bankr. N.D. Ill. 1986) (burden of proof on every element is on the person claiming that transfer was fraudulent, the debtor in this case); *Ear, Nose & Throat Surgeons, Inc. v. Guaranty Bank & Trust Co.* (*In re Ear, Nose & Throat Surgeons, Inc.*), 49 B.R. 316, 319 (Bankr. D. Mass. 1985) (holding in § 548 cases burden is on party seeking to avoid the transfer); *Emerald Hills Country Club, Inc. v. Hollywood, Inc.* (*In re Emerald Hills Country Club, Inc.*), 32 B.R. 408, 414 (Bankr. S.D. Fla. 1983) (stating trustee or debtor in possession has burden of proof); *Kanashy v. Randolph* (*In re R. Purbeck & Assoc., Ltd.*), 27 B.R. 953, 954 (Bankr. D. Conn. 1983) (holding burden of proof as to fraudulent transfer on trustee); *Hemphill v. T & F Land Co.* (*In re Hemphill*), 18 B.R. 38, 48 (Bankr. S.D. Iowa 1982) (holding burden of proof on debtors in possession); *Campbell v. Thamaes* (*In re Thames*), 21 B.R. 704, 706 (Bankr. D.S.C. 1981) (stating burden of proof on trustee).

160. *Ossen v. Bernatovich* (*In re National Safe N.E., Inc.*), 76 B.R. 896, 901 (Bankr. D. Conn. 1987); see, e.g., *Talbot v. Warner* (*In re Warner*), 65 B.R. 512, 518-19 (Bankr. S.D. Ohio 1986); *Emerald Hills Country Club, Inc. v. Hollywood, Inc.* (*In re Emerald Hills Country Club, Inc.*), 32 B.R. 408, 420 (Bankr. S.D. Fla. 1983).

when the trustee establishes a *prima facie* case.¹⁶¹ Also, in a few constructive fraud cases, courts have recognized presumptions whereby certain facts, although themselves failing to establish insolvency or inequivalency, nevertheless establish a *prima facie* case and shift the burden of proof to the defendant.¹⁶² The purpose of this section is manifestly simple: to protect a debtor's creditors from unfair reductions in the debtor's estate. As a result of this protection, creditors "need not monitor debtors so closely, and the savings in monitoring costs make businesses more productive."¹⁶³

In the attorneys' fees context, the most critical question for section 548 purposes centers around retainer agreements.¹⁶⁴

161. *Dunlavy v. Uhlmeier (In re Uhlmeier)*, 67 B.R. 977, 980 (Bankr. D. Ariz. 1986).

162. *See, e.g., United States v. Gleneagles Inv. Co.*, 565 F. Supp. 556, 577 (M.D. Pa. 1983) (stating that under Pennsylvania law once a creditor shows a conveyance was made without fair consideration, duty to prove solvency shifts to transferee), *aff'd sub nom. United States v. Tabor Court Realty Corp.*, 803 F.2d 1288 (3d Cir. 1986), *cert. denied sub nom. McClellan Realty Co. v. United States*, 483 U.S. 1005 (1987); *United States v. West*, 299 F. Supp. 661, 665 (D. Del. 1969) (stating that in a constructive fraud case under state law, proof of transfer to close relative and unsupported by fair consideration shifts burden to defendant to show solvency); *Ossen v. Bernatovich (In re National Safe N.E., Inc.)*, 76 B.R. 896, 902 (Bankr. D. Conn. 1987) (holding that transferee who is a fiduciary, such as an officer of the transferor, bears the burden of proving good faith and fair dealing); *Reigle v. Leinheiser (In re Leinheiser)*, 51 B.R. 164, 166 (Bankr. E.D. Pa. 1985) (stating that state law on constructive fraud provides that when the transferor made the transfer while in debt and transferred the property to a family member, the burden shifts to the transferee to show transferor's solvency at the time of the transfer); *Garrett v. Faulkner (In re Royal Crown Bottlers, Inc.)*, 23 B.R. 28, 31 (Bankr. N.D. Ala. 1982) (noting in dicta that once trustee shows that debtor received no direct benefit from the transfer, transferee must establish value to debtor); *Pirrone v. Toboroff (In re Vaniman Int'l, Inc.)*, 22 B.R. 166, 185-86 (Bankr. E.D.N.Y. 1982) (stating that in a case involving a transfer to corporate insiders, a presumption of insolvency arises when a person makes a transfer while indebted); *O'Connel v. Hoban (In re Famous State Fair Meat Products, Inc.)*, 19 B.R. 48, 50 (Bankr. E.D. Pa. 1982) (when transfer is to corporate director, the burden is on the transferee to prove good faith and fairness of consideration, and in the absence of such proof there is constructive fraud).

163. *Bonded Fin. Serv. v. European Am. Bank*, 838 F.2d 890, 892 (7th Cir. 1988).

164. *See, e.g., Quinn v. Union Nat'l Bank*, 32 F.2d 762, 771 (8th Cir. 1929) (interpreting the Bankruptcy Act of 1898, the court held a prepetition retainer void to the extent it was for future services, saying, "To say that one who is anticipating future trouble in the way of criminal actions or civil actions, and who may need the services of a lawyer, can make a transfer of his property just prior to bankruptcy proceedings and when he is in fact insolvent, and claim that there is a present consideration because of the promise of the attorneys to attend to these indefinite and uncertain legal procedures, is virtually to destroy the purpose of the Bankruptcy Law. It opens wide the door to unlimited

Assume, for example, that debtor *X* established a general (or classic) retainer with an attorney for \$50,000. At the time of the agreement, *X*'s liabilities exceeded her assets by a ratio of almost two to one. Moreover, the terms of the retainer agreement obligated the attorney to serve as *X*'s counsel should the need arise. The parties signed the retainer agreement and *X* made the payment six months before she ultimately filed for bankruptcy relief. Following the payment, the attorney did not actually perform any services for *X*, she only made herself available to do so should the need arise.

Arguably, these facts satisfy the elements of a constructively fraudulent transfer. There was a transfer from *X* to her attorney. The transfer occurred within the one year period preceding bankruptcy. At the time *X* made the transfer she was insolvent because her liabilities exceeded her assets. Finally, in exchange for the \$50,000 payment, *X* received merely a promise of future services and availability.

Central to this analysis is the question of whether the debtor, *X*, actually received less than "reasonably equivalent value." More fundamentally, does a promise to perform any necessary future services constitute value and, if so, is such value "reasonably equivalent" to the \$50,000 payment? Section 548 defines "value" as including "property, or satisfaction or securing of a present or antecedent debt of the debtor, but does not include an unperformed promise to furnish support to the debtor or to a relative of the debtor."¹⁶⁵ On its face, this definition suggests that an executory promise is not "value" for section 548 purposes. Indeed, several courts have opined that this statutory definition of "value" leaves "no room for a mere executory promise from the transferee as constituting that value."¹⁶⁶ Thus,

fraud. . ."); *FDIC v. Cafritz*, 762 F. Supp. 1503, 1502 n.11 (D.D.C. 1991) (stating in dicta that "the FDIC could certainly make some showing that the retainers were fraudulent conveyances under 11 U.S.C. §§ 544(b), 548, and 550"); *Wootton v. Ravkind* (*In re Dixon*), 143 B.R. 671, 680-81 (Bankr. N.D. Texas 1992) (holding prepetition retainer paid to attorney for representation in future criminal proceedings voidable as a fraudulent conveyance under § 548); *In re Hathaway Ranch Partnership*, 116 B.R. 208, 216 (Bankr., C.D. Cal. 1990) (discussing the possibility of attacking as fraudulent a prepetition retainer); *In re McDonald Bros. Constr., Inc.*, 114 B.R. 989, 1000 n.13 (Bankr. N.D. Ill. 1990) (holding excessive security retainer recoverable as fraudulent conveyance under § 548).

165. 11 U.S.C. § 548(d)(2)(A) (1988).

166. *Blackwell v. Wallace* (*In re Wallace*), 66 B.R. 834, 844 (Bankr. E.D. Mo. 1986); see also *Gray v. Snyder*, 704 F.2d 709, 711 (4th Cir. 1983) ("[R]easonably equivalent value under section 584 excludes future consideration, at least to the extent not actually performed."); *Bailey v. Metzger, Shadyac & Schwarz* (*In re*

both the Code definition of value and existing case law indicate that *X* received no value for section 548 purposes merely from her attorney's bare promise to furnish future legal services.

Yet, in this example, *X* arguably received more than a simple promise of future services. In addition, *X* received a commitment of her attorney's future availability should the need arise—a commitment which may be "economically beneficial" to the debtor, and hence value,¹⁶⁷ if the attorney's services are particularly desirable or useful in undertaking a bankruptcy proceeding. This particular attorney's expertise and availability may provide an economic benefit to *X* in the bankruptcy proceeding. Thus, one could argue that a debtor benefits in a broader

Butcher), 72 B.R. 447, 450 (Bankr. E.D. Tenn. 1987) (holding that promise to perform legal services is outside the scope of value under section 548); *In re Total Acquisition Corp.*, 29 B.R. 836, 840 (Bankr. S.D. Fla. 1983) (implying that promissory note and other executory promises are value only to the extent that the promises they represent are performed).

167. Courts regularly read "economic benefit" into the meaning of value. See, e.g., *Ransier v. Public Employees Retirement Sys. (In re Cottrill)*, 118 B.R. 535, 537 (Bankr. S.D. Ohio 1990) (stating that § 548(a)(2) requires "an economic benefit flowing to the entity making the transfer"); *Ohio Corrugating Co. v. DPAC, Inc. (In re Ohio Corrugating Co.)*, 91 B.R. 430, 436 (Bankr. N.D. Ohio 1988) (holding that the standard for reasonably equivalent value requires the debtor to have received a direct or indirect "economic benefit"); *W.E. Tucker Oil Co. v. First State Bank (In re W.E. Tucker Oil Co.)*, 55 B.R. 78, 81 (Bankr. W.D. Ark. 1985) (holding that lien was not given for value because debtor derived no "economic benefit").

The most influential authority on the economic benefit requirement was *Rubin v. Manufacturers Hanover Trust Co.*, 661 F.2d 979 (2d Cir. 1981), decided under the old Bankruptcy Act's fraudulent transfer provision. Under the Bankruptcy Act, the element of constructive fraud comparable to the Bankruptcy Code's "reasonably equivalent value" element was "fair consideration." See Bankruptcy Act § 67(d)(1)(e), 11 U.S.C. § 107(d)(1)(e) (repealed 1978). The meaning of the two terms is essentially the same. See *Bates v. Two Rivers Constr. (In re Bates)*, 32 B.R. 40, 41 (Bankr. E.D. Cal. 1983); *Murdock v. Plymouth Enters. (In re Curtina Int'l, Inc.)*, 23 B.R. 969, 974 (Bankr. S.D.N.Y. 1982).

The *Rubin* court held that fair consideration requires economic benefit. In defining the meaning of reasonably equivalent value under the Bankruptcy Code, many courts have cited *Rubin* and upheld transfers that involve an economic benefit to the debtor, while avoiding transfers that lack such a benefit. See, e.g., *Corporate Jet Aviation v. Vantress (In re Corporate Jet Aviation, Inc.)*, 82 B.R. 619, 622 (N.D. Ga. 1987), *aff'd*, 838 F.2d 1220 (11th Cir. 1988); *Musso v. Herman (In re Tesmetges)*, 85 B.R. 683, 697 (Bankr. E.D.N.Y. 1988); *In re Augie/Restivo Baking Co.*, 87 B.R. 242, 247 (Bankr. E.D.N.Y. 1988); *Johnson v. First Nat'l Bank*, 81 B.R. 87, 88 (Bankr. N.D. Fla. 1987); *Murphy v. Capital Bank (In re Duque Rodriguez)*, 77 B.R. 944, 946 (Bankr. S.D. Fla. 1987); *Lawrence Paperboard Corp. v. Arlington Trust Co. (In re Lawrence Paperboard Corp.)*, 76 B.R. 866, 874 (Bankr. D. Mass. 1987); *Martin v. Phillips (In re Butcher)*, 58 B.R. 128, 130 (Bankr. E.D. Tenn. 1986); *Hassett v. Far W. Fed. Sav. and Loan Assoc. (In re O.P.M. Leasing Services, Inc.)*, 40 B.R. 380, 396 (Bankr. S.D.N.Y. 1984), *aff'd*, 44 B.R. 1023 (D.N.Y.).

economic sense whenever, as in this case, it receives services or a commitment to perform future services that add "property to the debtor's estate or reduce the debtor's liability."¹⁶⁸ The fact that the sole executory promise that the Bankruptcy Code explicitly excludes from the definition of value is a promise "to furnish support to the debtor or to a relative of the debtor" buttresses this argument. This exclusion creates a strong negative implication that any other kind of enforceable executory promise constitutes value for purposes of section 548.

Importantly, even if the debtor establishes that the attorney's commitment is value, she must still establish that it is "reasonably equivalent" to the \$50,000 payment. The Bankruptcy Code does not define the term "reasonably equivalent."¹⁶⁹ Most courts, however, have found that the phrase generally implies a "fair economic bargain,"¹⁷⁰ without requiring a "penny-for-penny" exchange.¹⁷¹ When measuring equivalency, courts

168. 2 EPSTEIN ET AL., *supra* note 122, at 24. Courts have made clear that value also includes other kinds of intangible consideration that benefit the debtor without returning a leivable asset to the estate. *See, e.g.,* Merrill v. Allen (*In re* Universal Clearing House Co.), 60 B.R. 985, 998-1000 (D. Utah 1986) (holding that payment of commissions to sales agents is value); Freidman v. Grossman (*In re* Trauger), 105 B.R. 120, 123 (Bankr. S.D. Fla. 1989) (holding debtor received value from attorney's services); Bailey v. Metzger, Shadyac & Schwarz (*In re* Butcher), 72 B.R. 447, 450 (Bankr. E.D. Tenn. 1987) (stating value includes debt for past services); Ellenberg v. Chapel Hill Harvester Church, Inc. (*In re* Moses), 59 B.R. 815, 818 (Bankr. N.D. Ga. 1986) (holding that services are property that constitute value).

169. Most courts interpret reasonably equivalent value as essentially the modern equivalent of the old Bankruptcy Act's "fair consideration." *See supra* note 167. Fair consideration meant:

(1) when, in good faith, in exchange and as a fair equivalent therefor, property is transferred or an antecedent debt is satisfied, or (2) when such property or obligation is received in good faith to secure a present advance or antecedent debt in an amount not disproportionately small as compared with the value of the property or obligation obtained.

Bankruptcy Act § 67(d)(1)(e)(1),(2), 11 U.S.C. § 107d(1)(e) (repealed 1978).

170. *See* Cooper v. Ashley Communications, Inc. (*In re* Morris Communications NC, Inc.), 914 F.2d 458, 466-67 (4th Cir. 1990) (holding that reasonably equivalent value requires a case by case determination and an analysis of numerous factors); *see also* Jacoway v. Anderson (*In re* Ozark Restaurant Equipment Co.), 850 F.2d 342, 344-45 (8th Cir. 1988) ("The concept of reasonably equivalent value is a means of determining if the debtor received a fair exchange in the market place for the goods transferred.").

171. Varon v. Trimble, Marshall & Goldman (*In re* Euro-Swiss Int'l Corp.), 33 B.R. 872, 885 (Bankr. S.D.N.Y. 1983) ("Reasonably equivalent value requires only a 'full and adequate' consideration, not a penny-for-penny exchange."); *see* RIS v. Society for Savs. (*In re* Countdown of Conn., Inc.), 115 B.R. 18, 21 (Bankr. D. Conn. 1990) ("some disparity between the value of [what is transferred] and the value of [what the debtor receives] does not necessarily lead to a finding of lack of reasonably equivalent value"); Sorenson v. Tire Holdings Ltd.

have also focused on the value of what the debtor obtained, not the value of what the transferee gave up.¹⁷² Moreover, these courts have required that all the direct and indirect benefits the debtor received be taken into account.¹⁷³

This analysis demands a consideration of all the benefits X received from retaining this particular attorney. Although equivalency is a factual question, the fees debtors have traditionally paid to retain counsel suggest that a \$50,000 payment may be "reasonably equivalent."¹⁷⁴

Suppose, now, that X provides her attorney with a special retainer payment before bankruptcy to cover fees incurred before and during the case. This retainer could be either an advance fee payment or a security retainer. Upon filing, the retainer (really the debtor's equity in it) becomes estate property but by common practice the lawyer holds the money in trust and applies it against her fees. In this instance, any fees earned prepetition do not constitute a fraudulent transfer under section 548 so long as the lawyer provided services "reasonably equivalent" in value to the charges she posted against X's account.

Arguably, however, the lawyer lacks any interest in the retainer for postpetition services. Pursuant to section 549 of the Bankruptcy Code, "the trustee may avoid a transfer of property of the estate . . . that occurs after the commencement of the case."¹⁷⁵ Here, the money the debtor's attorney holds in trust is estate property.¹⁷⁶ Accordingly, the trustee could avoid any attempt by X's attorney to pay herself from estate funds for

(*In re Vinzant*), 108 B.R. 752, 759 (Bankr. D. Kan. 1989) (holding that value that is "roughly equal" is reasonably equivalent value).

172. See, e.g., *Consove v. Cohen (In re Roco Corp.)*, 701 F.2d 978, 982 (1st Cir. 1983); *Sorenson v. Tire Holdings Ltd. (In re Vinzant)*, 108 B.R. 752, 759 (Bankr. D. Kan. 1989); *Martin v. Phillips (In re Butcher)*, 58 B.R. 128, 130 (Bankr. E.D. Tenn. 1986); *Meister v. Jamison (In re Jamison)*, 21 B.R. 380, 381-82 (Bankr. D. Conn. 1982). This is a corollary to the rule that value obtained by someone other than the debtor for property the debtor transferred, or for an obligation she incurred, is not a factor in deciding whether the transfer or obligation was fraudulent. See *McColley v. Rosenberg (In re Candor Diamond Corp.)*, 76 B.R. 342, 349 (Bankr. S.D.N.Y. 1987).

173. See, e.g., *Join-In Int'l (U.S.A.) Ltd. v. New York Wholesale Distrib. (In re Join-In Int'l (U.S.A.) Ltd.)*, 56 B.R. 555, 560 (Bankr. S.D.N.Y. 1986).

174. Cf. *Wooten v. Ravkind (In re Dixon)*, 143 B.R. 671 (Bankr. N.D. Tex. 1992) (ordering criminal defense attorney to remit \$235,000 of a \$300,000 retainer as not being reasonably equivalent to criminal defense services performed).

175. 11 U.S.C. § 549(a)(2) (1988).

176. See *supra* notes 64-89 and accompanying text.

postpetition services. The attorney's interest in the retainer cannot grow to secure postpetition fees because this growth would either be prevented by the Code's automatic stay provision¹⁷⁷ or constitute an avoidable postpetition transfer of property under section 549(a)(1).¹⁷⁸

This argument is not indisputable. Some authorities would likely argue that the growth of the security interest does not constitute a postpetition transfer.¹⁷⁹ Also, in practice, the court typically approves a retainer for the debtor's attorney when it approves the attorney's employment. This approval may be the functional equivalent of authorizing a lien under section 364.¹⁸⁰ In any event, the argument against the attorney having an in-

177. 11 U.S.C. § 362(a) (1988 & Supp. IV 1993).

178. 11 U.S.C. § 549(a)(1) (1988).

179. *E.g.*, *In re Briggs Transp. Co.*, 37 B.R. 76 (Bankr. D. Minn. 1984). The relevant issue in *Briggs* was the timing of a transfer in the form of a security interest given to secure a bank's right of reimbursement as issuer of a letter of credit. *Id.* Chief Bankruptcy Judge Robert Kressel held that the transfer occurred when the bank issued the letter of credit rather than when the bank paid a draft drawn against the credit. *Id.*; see also *Luring v. Miami Citizens Nat'l Bank & Trust Co. (In re Val Decker Packing Co.)*, 61 B.R. 831, 839 (Bankr. S.D. Ohio 1986) (transfer occurred when debtor pledged property rather than when the issuer looked to property for reimbursement).

These cases do not entirely address the argument that the debtor's attorney's security interest in the security retainer for postpetition services is a postpetition transfer. First, to say that the initial creation of the interest is a transfer does not deny that subsequent growth of the interest is also a transfer. A single security transaction can involve—from start to finish—multiple transfers. Second, a letter of credit irrevocably obligates a secured party-bank to the beneficiary to perform. The obligation is contingent but solid. A debtor's attorney's contract of representation is not necessarily so firm. The retainer may secure services that *may* be rendered, not services that *will* be rendered. In this event, the attorney makes no contractual commitment that is itself value, yet a security interest requires value. See U.C.C. § 9-203(1)(b). Similarly, the attorney's lack of commitment spells a lack of mutuality that frees the debtor from any obligation. A security interest cannot exist without a corresponding obligation by the debtor. Indeed, the very meaning of the term "security interest" assumes an obligation to secure. See U.C.C. § 1-201(37). In these circumstances, no security interest for postpetition services exists until the attorney actually renders the services postpetition.

180. See 11 U.S.C. § 364 (c)-(d) (1988) (authorizing postpetition credit that is secured by a lien on property of the estate).

It is possible that § 364 could be applied literally and directly to obtain and secure credit for postpetition services, even in the absence of a retainer. *But see In re Roamer Linen Supply, Inc.*, 30 B.R. 932, 935 (Bankr. S.D.N.Y. 1983) (holding that an attorney authorized by the court to represent a debtor is not a "creditor" of the estate who can look to section 364(d) for superpriority status). In any event, doing so would require a hearing and decision of superpriority before the attorney rendered the services. Priority under § 364 cannot be authorized post facto, nor cover prepetition fees. See *Shapiro v. Saybrook Mfg. Co. (In re Saybrook Mfg. Co.)*, 963 F.2d 1490 (11th Cir. 1992) (holding that sections 364(c)

terest in the retainer is rarely made. Courts commonly allow the debtor's attorney to charge postpetition fees against a prepetition security retainer as if the attorney had secured the funds for this purpose. The courts thereby imply what the court expressly decided in *In re Viscount Furniture Corp.*,¹⁸¹ that "the law firms' security interests in the retainers extend to the respective amounts approved by the court as allowed claims."¹⁸²

Assuming that the trustee can avoid an attorney fee payment via retainer or otherwise pursuant to section 547, section 548, or section 549 of the Bankruptcy Code, an interesting subsidiary issue arises: whether a secured creditor can benefit from the exercise of such avoidance powers? Usually, secured creditors are avoidance victims. Moreover, as a general rule, any property the estate acquires after commencing the case will not be subject to a prepetition security interest.¹⁸³ Some courts, recognizing this fact, have concluded that the trustee's recoveries pursuant to her avoidance powers cannot subsequently "be subject[ed] to a security interest."¹⁸⁴ As they contend, employing the avoidance powers in this fashion "results in the use of powers created by the Bankruptcy Code for the benefit of one creditor alone, and is to be avoided."¹⁸⁵ These courts maintain that the avoidance powers exist to "implement the equal distribution of assets among the various classes of claims in the estate," and not merely to benefit the secured creditor.¹⁸⁶

Other courts, however, assert that a secured creditor can recover the monies the trustee obtains through her avoidance powers,¹⁸⁷ citing an exception to section 552(b)'s general rule¹⁸⁸ as

& (d) apply only to future—i.e., postpetition—extensions of credit; they do not authorize the granting of liens to secure prepetition credit).

181. 133 B.R. 360 (Bankr. N.D. Miss. 1991).

182. *Id.* at 367. In some cases, a different and more legitimate explanation may be that no competing claims to the retainer, as estate property, trump the lawyer's unsecured, but priority, administrative-expense claim.

183. 11 U.S.C. § 552(a) (1988).

184. *Mellon Bank v. Glick (In re Integrated Testing Prods. Corp.)*, 69 B.R. 901, 905 (D. N.J. 1987); see, e.g., *McFoldrick v. Juice Farms, Inc. (In re Ludford Fruit Prod., Inc.)*, 99 B.R. 18, 25 (Bankr. C.D. Cal. 1989); *Meridian Bank v. Bell Fuel Corp. (In re Bell Fuel Corp.)*, 97 B.R. 193, 198 (Bankr. E.D. Pa. 1989); *In re Tek-Aids Indus.*, 145 B.R. 253, 256 (Bankr. N.D. Ill. 1992).

185. *Sun Island Foods*, 125 B.R. at 619.

186. *Ludford Fruit Prods., Inc.*, 99 B.R. at 25.

187. See, e.g., *In re Enserv Company, Inc.*, 64 B.R. 519, 521 (Bankr. 9th Cir.); *Claussen Concrete Co. v. Walker (In re Lively)*, 74 B.R. 238 (S.D. Ga. 1987); *Official Unsecured Creditors' Comm. v. Norther Trust Co. (In re Ellingsen Maclean Oil Co.)*, 98 B.R. 284, 287 (Bankr. D. Mich. 1989); *In re Figearo*, 79 B.R. 914, 917 (Bankr. D. Nev. 1987); *In re Cambria Clover Mercantile Co.*, 51 B.R. 983, 986 (Bankr. E.D. Pa. 1985); *Mitchell v. Rock Hill Nat'l Bank (In re*

the basis of their conclusion.¹⁸⁹ Section 552(b) provides that a secured creditor's interest in proceeds from secured collateral continues postpetition. These courts contend that applying the general section 552(a) rule "to avoid a security interest in property recovered through the trustee's avoiding powers . . . go[es] beyond what the statute was designed to accomplish."¹⁹⁰

This Article adopts the latter view. To hold that secured parties lose their prepetition lien as to proceeds of preferential transfers would be contrary to both the language of section 552(b) and Congress's intent to prevent inequitable treatment of creditors.¹⁹¹ Moreover, because a debtor's collateral will often be entirely encumbered by the liens of secured parties so that the unsecured creditors will receive nothing, the only creditors who stand to be harmed by the preferential transfer are the secured parties. As the court adeptly observed in *In re Ellingsen*, "I do not believe that it was the intent of Congress that recovered preferential transfers would not inure to the benefit of the one creditor that was harmed by such transfer."¹⁹²

III. ATTORNEY-RECIPIENT'S DEFENSES TO CHALLENGES A OF SECURED PARTY

An attorney who has received a payment from secured collateral can offer a number of defenses to a secured party's direct and indirect challenges. With regard to the secured party's conversion proceeding, the attorney-recipient can maintain that the secured party explicitly or implicitly authorized the transfer of collateral to the attorney.¹⁹³ Alternatively, the attorney can argue that, pursuant to the common law rule of negotiability, it should prevail over the secured party as a "holder in due course

Mid-Atlantic Piping), 24 B.R. 314, 321-25 (Bankr. W.D.N.L. 1982); see also Nancy L. Sanborn, Note, *Avoidance Recoveries in Bankruptcy: For the Benefit of the Estate or the Secured Creditor?*, 90 COLUM. L. REV. 1376, 1398-1400 (1990) (arguing that a security interest in avoidance recoveries is appropriate in certain circumstances).

188. 11 U.S.C. § 552(b) (1988).

189. See, e.g., *Cambria*, 51 B.R. at 987; *Mid-Atlantic*, 24 B.R. at 323.

190. *Figearo*, 79 B.R. at 918.

191. See H.R. REP. NO. 595, 95th Cong., 2d. Sess. 177-78, reprinted in 1978 U.S.C.C.A.N., 5963, 6138-39.

192. Official Unsecured Creditors' Comm. v. Norther Trust Co. (*In re Ellingsen Maclean Oil Co.*), 98 B.R. 284, 291 (Bankr. D. Mich. 1989).

193. U.C.C. § 9-306(2) ("[A] security interest continues in collateral notwithstanding sale, exchange, or other disposition thereof unless the disposition was authorized by the secured party in the security agreement or otherwise . . .").

of a negotiable instrument.”¹⁹⁴ In the context of an indirect challenge, the attorney can contend either that the transfer falls within a section 547(c)¹⁹⁵ exception to section 547(b), or constitutes a transfer that may not be avoided under the fraudulent conveyance requirements of section 548.

A. ATTORNEY-RECIPIENT'S DEFENSES TO A CONVERSION ACTION

1. Authorization

The secured party's conversion theory assumes that the security interest in the payment follows the funds into the recipient's hands. The security interest, however, ends when the payment is made if—“in the security agreement or otherwise”—the secured party authorizes the debtor to make the payment.¹⁹⁶ Thus, a secured party may waive her right to a security interest in collateral and the proceeds thereof either explicitly in the security agreement or implicitly by her actions.

a. *Explicit waiver.*

A secured party may explicitly authorize the transfer of collateral or the proceeds thereof and hence forfeit her rights in the collateral. Typically, such explicit authorization is contained in the security agreement.¹⁹⁷ For example, the security agreement may provide that the debtor “shall have the liberty to exhibit and to sell [the collateral] in the ordinary course of trade,”¹⁹⁸

194. U.C.C. § 9-309 (“Nothing in this Article limits the rights of a holder in due course of a negotiable instrument . . . and the holders or purchasers take priority over an earlier security interest even though perfected.”).

195. 11 U.S.C. § 547(c) (1988).

196. U.C.C. § 9-306(2).

197. See, e.g., *Centerre Bank v. New Holland Div. of Sperry Corp.*, 832 F.2d 1415, 1422-23 (7th Cir. 1987); *Swift & Co. v. Jamestown Nat'l Bank*, 426 F.2d 1099, 1103-04 (8th Cir. 1970); *In re Special Abrasives, Inc.*, 26 B.R. 399, 403 (Bankr. E.D. Mich. 1983); *In re Frank Meador Leasing, Inc.*, 6 B.R. 910, 913 (Bankr. W.D. Va. 1980); *Central Fin. Loan Corp. v. Bank of Ill.*, 500 N.E.2d 1066, 1069 (Ill. App. Ct. 1986); *Finance Am. Commercial Corp. v. Econo Coach, Inc.*, 454 N.E.2d 1127, 1129 (Ill. App. Ct. 1983); *Massey-Ferguson, Inc. v. Holland*, 434 N.E.2d 295, 300 (Ill. App. Ct. 1982); *Bitzer-Croft Motors, Inc. v. Pioneer Bank & Trust Co.*, 401 N.E.2d 1340, 1346 (Ill. App. Ct. 1980); *First Fin. Co. v. Akathoitis*, 249 N.E.2d 663, 665 (Ill. App. Ct. 1969); *Universal C.I.T. Credit Corp. v. Middlesboro Motor Sales, Inc.*, 424 S.W.2d 409, 413 (Ky. 1968); *Crystal State Bank v. Columbia Heights State Bank*, 203 N.W.2d 389, 390-91 (Minn. 1973); *Home Sav. Ass'n v. General Elec. Credit Corp.*, 708 P.2d 280, 288 (Nev. 1985) (per curiam); *Whirlpool Corp. v. Dailey Const., Inc.*, 429 S.E.2d 748, 750-751 (N.C. Ct. App. 1993); *Graves Constr. Co. v. Rockingham Nat'l Bank*, 263 S.E.2d 408, 411-12 (Va. 1980).

198. *Universal C.I.T. Credit*, 424 S.W.2d at 411-12.

that the debtor "shall be entitled to exhibit and sell [the collateral] in the regular course of trade,"¹⁹⁹ or authorize the disposition of the collateral "in the ordinary course of business upon customary terms for value received."²⁰⁰ In other instances, explicit authorization has been provided orally or in a writing separate from the security agreement.²⁰¹

In the case of attorneys' fee payments, however, the secured party will not likely provide the debtor with an express authorization to use secured collateral or proceeds for these payments either in, or apart from, the security agreement. Secured parties regularly provide express authorization for sales of secured collateral in the regular course of business for three reasons, none of which customarily takes place in the context of attorney fee payments. First, secured parties frequently provide express authorization for the sale of collateral in the ordinary course because they know their security interest will continue in the sale proceeds by virtue of section 9-306(2).²⁰² In the case of attorney fee payments, the express authorization would have to extend to proceeds as well, an unlikely event. In addition, secured parties often provide for the sale of collateral in the ordinary course because it is the debtor's business to sell such collateral, for instance, inventory. This rationale, of course, does not implicate attorneys' fee payments. Finally, express authorization in the inventory context is not really a concession by the secured party because, pursuant to section 9-307(1), a buyer in the ordinary course of business²⁰³ takes free of the security interest in the

199. *Bitzer-Croft Motors*, 401 N.E.2d at 1346.

200. *Massey-Ferguson, Inc.*, 434 N.E.2d at 297-98.

201. *Peoples State Bank v. Lutteke*, 445 N.W.2d 574, 578 (Minn. App. 1989) (holding that under proper facts "oral consent effectively extinguishes a secured party's interest in the sale of the collateral despite a provision in the security agreement that such consent must be in writing"); see *In re Klippfer*, 62 B.R. 290, 295 (Bankr. S.D. Ohio 1986) (finding authorization for sale of collateral); *Anon, Inc. v. Farmers Prod. Credit Ass'n*, 446 N.E.2d 656, 662 (Ind. Ct. App. 1983) (allowing express oral waiver); *Ottumwa Prod. Credit Association v. Keoco Auction Co.*, 347 N.W.2d 393, 396 (Iowa 1984); *Peoples Nat'l Bank & Trust v. Excel Corp.*, 695 P.2d 444, 447 (Kan. 1985) ("An express authorization by the secured party of the debtor to sell collateral and to receive the proceeds constitutes an express waiver of the security interest in the collateral sold."); *North Cent. Kan. Prod. Credit Ass'n v. Washington Sales Co.*, 577 P.2d 35 (Kan. 1978) (finding express consent to sale).

202. U.C.C. § 9-306(2).

203. A buyer is a "buyer in the ordinary course of business" if she buys "in good faith and without knowledge that the sale to him is in violation of the ownership rights or security interest of a third party" and buys the goods "from a person in the business of selling goods of that kind." U.C.C. § 1-201(9).

secured collateral.²⁰⁴ Importantly, an attorney-recipient in this case could not avail herself of this protection because she is not a buyer in the ordinary course. Consequently, one would expect secured parties to reject requests by the debtor or attorney-recipient for express authorization within or outside the security agreement.

b. *Implicit waiver.*

Even if the debtor or the attorney-recipient does not obtain the secured party's express authorization to pay attorneys' fees from secured collateral, courts have also concluded that, by virtue of the "or otherwise" language in section 9-306(2), a secured party can implicitly authorize the disposition of collateral.²⁰⁵ In particular, courts have often held that, notwithstanding language in a security agreement prohibiting a transfer of secured collateral, a prior course of dealing between the parties may be used to establish that the secured party impliedly consented to the transfer of particular secured collateral.²⁰⁶ In one typical

204. U.C.C. § 9-307(1); *see, e.g.*, *United States v. Continental Grain Co.*, 691 F. Supp. 1193, 1198 (W.D. Wisc. 1988); *Carey Aviation, Inc. v. Giles World Mktg., Inc.*, 46 B.R. 458, 461 (D. Mass. 1985); *Ensminger v. Burton*, 805 S.W.2d 207, 210 (Mo. Ct. App. 1991); *General Motors Acceptance Corp. v. Third Nat'l Bank*, 812 S.W.2d 593, 596 (Tenn. Ct. App. 1991); *Daniel v. Bank of Hayward*, 425 N.W.2d 416, 419 (Wisc. 1988).

205. U.C.C. § 9-306(2). Interestingly, comment 3 to section 9-306 in the 1962 version of the Uniform Commercial Code suggests:

A claim to proceeds in a filed financing statement might be considered as impliedly authorizing sale or other disposition of the collateral, depending upon the circumstances of the parties, the nature of the collateral, the course of dealing of the parties and the usage of trade (See Section 1-205).

U.C.C. § 306 cmt. 3 (1962) (amended 1972); *see, e.g.*, *E-4 Excavating, Inc. v. Lawrence Nat'l Bank & Trust Co.*, 101 B.R. 269 (D. Kan. 1989) (holding that where the secured party's officers expressly authorized a transfer of collateral, it gave its implied consent notwithstanding a clause in the security agreement that provided that borrower could not, "without the prior written consent of the lender" dispose of the collateral).

206. *See, e.g.*, *Moffat County State Bank v. Producers Livestock Mktg. Ass'n*, 598 F. Supp. 1562, 1568 (D. Colo. 1984), *aff'd* 833 F.2d 908 (10th Cir. 1987); *Producers Cotton Oil Co. v. Amstar Corp.*, 242 Cal. Rptr. 914, 916 (Cal. Ct. App. 1988); *Central Cal. Equip. Co. v. Dolk Tractor Co.*, 144 Cal. Rptr. 367, 371 (Cal. App. 1978); *Hedrick Sav. Bank v. Myers*, 229 N.W.2d 252 (Iowa 1975); *Humboldt Trust & Sav. Bank v. Entler*, 349 N.W.2d 778 (Iowa Ct. App. 1984); *Ottumwa Prod. Credit Assoc. v. Heinhold Hog Mkt., Inc.*, 340 N.W.2d 801, 802 (Iowa Ct. App. 1983); *Battista v. Sav. Bank*, 507 A.2d 203, 209 (Md. Ct. Spec. App. 1986); *Peoples State Bank v. Lutteke*, 445 N.W.2d 574, 577 (Minn. Ct. App. 1989); *Pieper v. First Nat'l Bank*, 453 S.W.2d 926, 930 (Mo. 1970); *Farmers State Bank v. Farmland Foods, Inc.*, 402 N.W.2d 277, 280 (Neb. 1987); *Gretna State Bank v. Cornbelt Livestock Co.*, 463 N.W.2d 795, 798 (Nev. 1990);

case, *National Livestock Credit Corp. v. Schultz*,²⁰⁷ the security agreement provided that the debtor could not dispose of the secured collateral without the secured party's written consent.²⁰⁸ In concluding that the secured party impliedly consented to the sale of the secured collateral notwithstanding the security agreement, the court relied on the fact that for two years the debtor had sold cattle to various packers without the secured party's prior written consent or knowledge and that the secured party had never rebuked the debtor for ignoring the terms of the security agreement.²⁰⁹ The court noted that the secured party's conduct constituted a waiver under the "or otherwise" language of section 9-306(2).²¹⁰

On occasion, courts have also recognized that, even though the security agreement prohibits a transfer of secured collateral, the secured party's knowledge of and acquiescence in the transfer will constitute authorization under section 9-306(2).²¹¹ In *In re Halmar Distributors, Inc.*,²¹² for example, General Electric had a security interest in the inventory it sold to Halmar, a wholesaler.²¹³ Until early 1989, Halmar had also maintained a revolving credit arrangement with Shawmut Bank.²¹⁴ In March 1989, Halmar entered into a similar financing arrangement with BayBank, pursuant to which BayBank made loans to Halmar in amounts determined by a formula based on the levels

Clovis Nat'l Bank v. Thomas, 425 P.2d 726, 730 (N.M. 1967); *National Livestock Credit Corp. v. Schultz*, 653 P.2d 1243, 1247 (Okla. Ct. App. 1982); *Bank of E. Or. v. Griffith*, 792 P.2d 1210, 1213 (Or. Ct. App. 1990); *Stone Fort Nat'l Bank v. Citizens State Bank*, 722 S.W.2d 508, 510 (Tex. Ct. App. 1986). *But see* *Vermilion County Prod. Credit Ass'n v. Izzard*, 249 N.E.2d 352, 355 (Ill. App. Ct. 1969); *Aberdeen Prod. Credit Ass'n v. Redfield Livestock Auction, Inc.*, 379 N.W.2d 829, 832 (S.D. 1985); *Swiden Appliance & Furniture, Inc. v. National Bank of S.D.*, 357 N.W.2d 271, 276-77 (S.D. 1984).

207. 653 P.2d 1243 (Okla. Ct. App. 1982).

208. *Id.* at 1244-45.

209. *Id.* at 1247.

210. *Id.*

211. *See, e.g., In re Halmar Distrib., Inc.* 968 F.2d 121, 121-22 (1st Cir. 1992). *But see* *Wegner v. Grunewaldt*, 821 F.2d 1317 (8th Cir. 1987); *Neu Cheese Co. v. FDIC*, 825 F.2d 1270, 1272-73 (8th Cir. 1987); *Citizens Sav. Bank v. Sac City State Bank*, 315 N.W.2d 20, 26 (Iowa 1982); *Peoples Nat'l Bank & Trust Corp. v. Excel Corp.*, 695 P.2d 444, 449 (Kan. 1985); *Cessna Fin. Corp. v. Skyways Enters., Inc.*, 23 U.C.C. Rep. Serv. 1015, 1019 (Ky. Ct. App. 1978); *McFadden v. Mercantile-Safe Deposit & Trust Co.*, 273 A.2d 198 (Md. 1971); *Pieper v. First Nat'l Bank*, 453 S.W.2d 926, 930 (Mo. 1970).

212. 968 F.2d 121 (1st Cir. 1992).

213. *Id.* at 122.

214. *Id.*

of current inventory and accounts receivable.²¹⁵ BayBank required Halmar's customers to make their payments directly to a lockbox under the bank's control and also took a security interest in all of Halmar's inventory, subsequent to General Electric's.²¹⁶

In October 1989, shortly before Halmar filed bankruptcy, General Electric sent a letter to BayBank objecting to the collection of Halmar's receivables through the lockbox arrangement, and specifically the sums attributable to the sales of General Electric products.²¹⁷ In the ensuing bankruptcy proceeding, the bankruptcy court rejected General Electric's conversion claim based on allegations that the bank had improperly reimbursed itself from lockbox payments attributable to purchases of General Electric products.²¹⁸ The First Circuit held that because over the years General Electric had acquiesced in a similar arrangement between Halmar and Shawmut, "[w]hatever rights General Electric, as the senior security holder, had over the bank to receipt of the proceeds, were waived."²¹⁹ Significantly, the court added, however, that General Electric's waiver was not "irrevocable,"²²⁰ noting that "[a]lthough General Electric's acquiescence insulated the bank from actions that occurred during the period before [General Electric's October 1989] notice, it did not confer any right to continue that conduct indefinitely."²²¹ Thus, General Electric's notice "effectively terminated the period of acquiescence."²²²

In the attorneys' fees context, these decisions offer the attorney-recipient a possible defense to the secured party's conversion action. Pursuant to these decisions, the attorney-recipient may point to either a prior course of dealing between the parties or the secured party's acquiescence as proof of the secured party's implicit authorization of payment to the attorney. Specifically, the attorney-recipient may argue that the secured party's past implicit consent to transfers to parties similarly situated to the attorney-recipient should protect her in this in-

215. *Id.*

216. *Id.* at 122-23.

217. *Id.* at 123.

218. *Id.*

219. *Id.* at 129.

220. *Id.* at 130.

221. *Id.*

222. *Id.*; see also *C&H Farm Serv. Co. v. Farmers Sav. Bank*, 449 N.W.2d 866, 871 (Iowa 1989) ("[A] secured party's rights under a security agreement, though waived by a prior course of dealing, may be reasserted by giving reasonable notice to the debtor that the creditor intends to do so.").

stance. The attorney-recipient may even point to *In re Halmar Distributors, Inc.*, in which the court noted that General Electric's acquiescence with respect to one party (Shawmut) carried over to a similarly situated party (BayBank). Of course, as the *Halmar* decision also indicates, the secured party may terminate its implicit consent by taking affirmative steps to reassert its rights under section 9-306(2).

2. Priority

a. *Common-law rule of negotiability.*

Typically, when the attorney receives payment for services she has rendered or will render for a party in or near bankruptcy, the payment is made from a bank account. Nothing in the body of Article 9 protects the attorney-recipient in this instance, but comment 2(c) to section 9-306 gives the recipient priority over a secured party's interest in proceeds "[w]here cash proceeds are covered into the debtor's checking account and paid out in the operation of the debtor's business."²²³ In this situation, the recipient "of the funds . . . take[s] free of any claim which the secured party may have in them as proceeds . . . [so long as the] payments and transfers [are] in [the] ordinary course."²²⁴

Although the source of this comment is not expressed in Article 9's commentary, PEB Commentary Number 7²²⁵ explains that it partially arises from the relationship between Article 3 and Article 9. Commentary 7 highlights the significance of section 9-309,²²⁶ by which Article 9 defers to the Article 3 holder in due course doctrine. A holder in due course is a holder of a negotiable instrument who took the instrument for value, innocently, and in good faith.²²⁷ Under Article 3, a person having the rights of a holder in due course takes free of any competing claim of a property or possessory right in the instrument or its proceeds,²²⁸

223. U.C.C. § 9-306 cmt. 2(c).

224. *Id.*

225. Permanent Editorial Board Commentary on the Uniform Commercial Code No. 7 (March 10, 1990) (The Relative Priorities of Security Interests in the Cash Proceeds of Accounts, Chattel Paper, and General Intangibles).

226. "Nothing in this Article limits the rights of a holder in due course of a negotiable instrument . . . and the holders or purchasers take priority over an earlier security interest even though perfected." U.C.C. § 9-309.

227. "A holder in due course is a holder who takes the instrument . . . for value; and . . . in good faith; and . . . without notice that it is overdue or has been dishonored or of any defense. . . ." U.C.C. § 3-302(1).

228. U.C.C. § 3-306.

including a claim to a lien.²²⁹ Through section 9-309, Article 9 defers to section 3-306 and enables an ordinarily subordinate party, who is a holder in due course, to take free of a senior security interest in Article 3 negotiable instruments.²³⁰

Notably, comment 2(c) and Commentary 7 are specific applications of a broader common law principle, the negotiability of money, that explains the historical basis of the holder-in-due-course doctrine. As explained a century ago in the classic case *Merchants' Loan & Trust Co. v. Lamson*:²³¹

[E]ven if money transferred to an honest taker was obtained by the one transferring it through a felony, yet the honest taker, who received it without knowledge of the felony and in due course of business, would acquire good title as against the one from whom it was stolen. In most of the cases . . . cited, the rule is applied to commercial paper, but the same rule applies with even greater force to currency. Indeed, the rule as applied to negotiable paper is derived from and based upon the English rule as originally applied to coin or other forms of currency. The exception to the general rule of the common law that the purchaser of a chattel can acquire no better title than the vendor, was first applied to money, i.e., currency, and then extended in its application to negotiable paper.²³²

In short, money "never shall be followed into the hands of a person who bona fides took it in the course of currency and in the way of his business."²³³

This principle of the negotiability of currency applies both when money itself is paid directly to a bona fide purchaser, the classic *Lamson* case,²³⁴ and also when the money is first channeled through a bank account.²³⁵ Similar to a holder in due

229. U.C.C. § 3-306 cmt.

230. See, e.g., *Allstate Fin. Corp. v. Financorp., Inc.*, 934 F.2d 55, 59 (4th Cir. 1991); *Farmers State Bank v. National Bank*, 596 N.E.2d 173, 174 (Ill. App. 1992); *Citizens Valley Bank v. Pacific Materials Co.*, 503 P.2d 491 (Or. 1972) (en banc); *Soloff v. Dollahite*, 779 S.W.2d 57, 60 (Tenn. Ct. App. 1989); *Dallas Bank & Trust Co. v. Frigiking, Inc.*, 692 S.W.2d 163, 166-67 (Tex. Ct. App. 1985).

231. 90 Ill. App. 18 (1899) (citations omitted).

232. *Id.* at 20; see ARTHUR NUSSBAUM, *MONEY IN THE LAW* 93-103 (1950); Eder, *Legal Theories of Money*, 20 CORNELL L.Q. 52, 55-57 (1934).

233. *Miller v. Race*, 97 Eng. Rep. 398, 402 (K.B. 1758). For an example of a modern day *Miller v. Race*, see *City of Portland v. Berry*, 739 P.2d 1041, 1043-44 (Or. Ct. App. 1987).

234. *Lamson*, 90 Ill. App. 18; see also *Holly v. Missionary Soc'y*, 180 U.S. 284, 293, (1901); *Fineberg v. Stone (In re Brainard Hotel)*, 75 F.2d 481, 483 (2nd Cir. 1935); *First Nat'l Bank v. Gibert & Clay*, 49 So. 593, 595-96 (La. 1909); *Babcock v. Standish*, 33 A. 385, 387-88 (N.J. Eq. 1895); *Transamerica Ins. Co. v. Long*, 318 F. Supp. 156, 160 (W.D. Pa. 1970).

235. See *Arlington Park Racetrack Ltd. v. SRM Computers, Inc.*, 674 F. Supp. 986, 992 (E.D.N.Y. 1987); *Porter v. Beha*, 8 F.2d 65, 74 (N.D.N.Y. 1925); *Newhall v. Longacre Bank*, 162 N.E. 23 (N.Y. 1928); *Stephens v. Board of Educ.*, 79 N.Y. 183, 186-88 (1879); *Matteawan Mfg. Co. v. Chemical Bank &*

course of a negotiable instrument, the bona fide purchaser of money is also fully protected even though she took the money for an antecedent debt rather than for new value or other consideration.²³⁶ Thus, "A can steal from B in order to pay a debt to C, and . . . where there are no substantial intervening equities . . . B cannot recover the proceeds from C."²³⁷

Under the common law, the secured party enjoys a position analogous to B's above. Pursuant to the common-law rule of negotiability reflected in comment 2(c), an Article 9 security interest in proceeds ends when the debtor pays money to an attorney in satisfaction of the attorney's bona fide claim, as long as the attorney takes the money in due course and is unaware of the security interest.²³⁸ The secured party maintains the same position, moreover, if the collateral is a negotiable instrument

Trust Co., 279 N.Y.S. 495, 502 (N.Y. App. Div. 1935), *aff'd as modified*, 3 N.E.2d 845 (N.Y. 1936).

236. The negotiability of money, as applied to creditors, is so well established that it supported an annotation more than 50 years ago. Annotation. *Duty of Innocent Creditor to Restore to Third Person Money or Other Property of the Latter Received as Result of Fraud or Mistake in Transaction Between Debtor and Third Person*, 114 A.L.R. 382 (1938).

237. See *In re Van Derpool's Will*, 153 N.Y.S.2d 687, 691 (N.Y. App. Div. 1956), *aff'd*, 143 N.E.2d 340 (1957) (Foster, J., dissenting) (describing this result as anomalous).

238. See, e.g., *J.I. Case Credit Corp. v. First Nat'l Bank*, 991 F.2d 1272, 1277-80 (7th Cir. 1993) (holding that payments by farm equipment company on debts owed to bank were taken free of security interest in proceeds from sale of farm equipment where proceeds were paid in ordinary course of business and without bank's knowledge that the debtor made payments with secured proceeds); *In re Halmar Distrib. Inc.*, 968 F.2d 121 (1st Cir. 1992) (holding that proceeds of inventory were paid to junior creditor); *Harley-Davidson Motor Co., Inc. v. Bank of New England*, 897 F.2d 611, 622 (1st Cir. 1990) (same); *Merchants Nat'l Bank & Trust Co. v. United States*, 202 Ct. Cl. 343 (1973) (per curiam) (noting that proceeds of accounts were used to pay taxes); *Stores West Corp. v. Exchange Nat'l Bank*, No. 84C10064, 1987 WL 5916 (N.D. Ill. Jan. 23, 1987) (holding that proceeds of inventory were paid to junior secured party); *Miami Valley Prod. Credit Ass'n v. Klipfer (In re Klipfer)*, 62 B.R. 290, 295 (Bankr. S.D. Ohio 1986) (holding that farm financier lost security interest in proceeds of crops that debtor paid by check to various landlords); *Tuloka Affiliates, Inc. v. Security State Bank*, 627 P.2d 816, 820-21 (Kan. 1981) (holding that inventory financier lost priority in proceeds of inventory that debtor deposited in its bank account and that bank debited to satisfy loan); *Anderson, Clayton & Co. v. First Am. Bank*, 614 P.2d 1091, 1094 (Okla. 1980) (holding that bank will take proceeds free of security interest if debtor pays bank, not by setoff, but by drawing against debtor's account at the bank, and the bank receives the payment in good faith and without knowledge that the receipt violated the security interest); *Commercial Discount Corp. v. Milwaukee W. Bank*, 214 N.W.2d 33, 39 (Wis. 1974) (holding that secured party could not recover proceeds from various government agencies who were the payees of checks drawn on the account in which the debtor had deposited proceeds).

which the attorney-recipient took as a holder in due course.²³⁹ Technically, of course, if the collateral is money drawn from a bank account by check, the common-law negotiability of money rather than the holder in due course doctrine governs although it produces an identical result. In that case, the issue is the right to the money itself and not the right to payment of the check.²⁴⁰

Thus, either the common-law principle of negotiability or

239. Surprisingly, recent decisions dispute such a broad rule, but they overlook §§ 9-309 and 3-306. *See, e.g.,* Bank of Okla. v. Islands Marina, Ltd., 918 F.2d 1476, 1481 (10th Cir. 1990) (per curiam); Linn Coop. Oil Co. v. Norwest Bank Marion, 444 N.W.2d 497, 499 (Iowa 1989). The courts that have considered these sections have reached the correct result, as in the most recent cases covered by Commentary 7. *See, e.g.,* Allstate Fin. Corp. v. Financorp, Inc., 934 F.2d 55 (4th Cir. 1991); *In re Joe Morgan, Inc.*, 130 B.R. 331 (Bankr. S.D. Ala. 1991), *aff'd in part, rev'd in part*, 985 F.2d 1554 (11th Cir. 1993); *see also In re Halmar Distrib., Inc.*, 968 F.2d 121 (1st Cir. 1992) (deciding that a bank took free of another creditor's security interest in proceeds paid into a lockbox, including proceeds that were checks endorsed to the bank, but relying on the broader principle of taking proceeds in the ordinary course rather than the holder-in-due-course doctrine); Rieth-Riley Constr. Co. v. First Security Bank (*In re Williams Bros. Asphalt Paving Co.*), 59 B.R. 71 (Bankr. W.D. Mich. 1986) (holding that bank's holder in due course status protects it from competing creditor's claims to funds); Farmers State Bank v. National Bank, 596 N.E.2d 173, 174 (Ill. App. Ct. 1992) (deciding that where debtor tendered check, the proceeds of crops, to defendant in partial payment of an unsecured promissory note, the defendant was a holder in due course and took free of plaintiff's security interest in check); First Nat'l Bank v. Creston Livestock Auction, Inc., 447 N.W.2d 132, 135 (Iowa 1989) (holding that holder in due course prevails against prior perfected secured party); Citizens Valley Bank v. Pacific Materials Co., 503 P.2d 491 (Or. 1972) (en banc) (stating that bank lost priority of its security interest in a negotiable promissory note that debtor negotiated to defendant). *But cf.* Farns Assocs., Inc. v. South Side Bank, 417 N.E.2d 818, 822-23 (Ill. App. Ct. 1981) (finding that security interest in checks that were proceeds could be enforced against bank to which debtor transferred them because the bank was not a holder in due course as the debtor had not properly endorsed check).

A holder in due course also takes free of liens other than security interests. *See, e.g.,* Bricks Unlimited, Inc. v. Agee, 672 F.2d 1255, 1258-60 (5th Cir. 1982) (holding that a holder in due course of a note took free of a garnishment lien, but overlooking the possibility that the lien never attached to the note because the maker was garnished rather than the payee); Soloff v. Dollahite, 779 S.W.2d 57, 58-60 (Tenn. Ct. App. 1989) (deciding that bank that was a holder in due course of notes took them free of state tax liens).

240. *But see* Merchants Nat'l Bank & Trust Co. v. United States, 202 Ct. Cl. 343 (1973) (per curiam) (explaining comment 2(c) in terms of holder in due course doctrine); McConico v. Third Nat'l Bank, 499 S.W.2d 874 (Tenn. 1973) (relying on Article 3 and the holder in due course doctrine to deny bankruptcy trustee's claim to funds that were drawn from the debtor's bank paid to a creditor); Commercial Discount Corp. v. Milwaukee W. Bank, 214 N.W.2d 33, 39 (Wis. 1974) (explaining comment 2(c) in terms of holder in due course doctrine).

Commentary 7 addresses a different case, one where the account debtors are liable on the checks as drawers. The issue is whether or not the holder's

the derivative holder in due course rule may protect the attorney-recipient of secured collateral proceeds. This protection is not necessarily denied even when the attorney knows that a blanket, floating encumbrance covers all the debtor's property.²⁴¹ As long as the debtor makes a payment of proceeds in the ordinary course, at least the First Circuit, in *Harley Davidson*, "can imagine good commercial reasons for not imposing, even upon sophisticated [parties, such as attorneys] . . . , who are aware that inventory financiers often take senior secured interests in 'all inventory plus proceeds,' the complicated burden of contacting those financiers to secure permission to take payment from a [debtor]."²⁴²

Critical to this protection, of course, is that the attorney-recipient must establish that the debtor made the payment in the "ordinary course." The *Harley-Davidson* court indicated that it would give "ordinary course" . . . a fairly broad meaning.²⁴³ Additionally, the Seventh Circuit has recognized that "a payment is within the ordinary course if it [is] made in the operation of the debtor's business and if the payee d[oes] not know and [is] not reckless about whether the payment violate[s] a third party's security interest."²⁴⁴ This Article adopts these views as consistent with comment 2(c) which distinguishes between individuals who take funds in the ordinary course of a debtor's business and recipients who have engaged in fraudulent, collusive or otherwise unfair behavior.²⁴⁵ As comment 2(c) further provides, "[t]he law of fraudulent conveyances would no doubt in appropriate cases support recovery of proceeds by a secured party from a transferee of ordinary course or otherwise in collusion with the debtor to defraud the secured party."²⁴⁶ This Article further contends that courts should determine ordinary course mainly, if not exclusively, from the attorney's perspective because the underlying policy of negotiability revolves entirely

enforcement of the checks is subject to the preexisting property claim of the senior creditor, an issue governed by § 9-309 and Article 3.

241. *But see* *Bank of Brewton v. GMAC*, 811 F. Supp. 648, 651 (S.D. Ala. 1992) (holding payments to bank were not made in the "ordinary course," where bank, by virtue of dishonored checks, was on notice that dealership had obligation to senior creditor it could not meet).

242. *Harley-Davidson Motor Co. v. Bank of New England*, 897 F.2d 611, 622 (1st Cir. 1990).

243. *Id.*

244. *J.I. Case Credit v. First Nat'l Bank*, 991 F.2d 1272, 1279 (7th Cir. 1993).

245. U.C.C. § 9-306 cmt. 2(c).

246. *Id.*

around the rights of transferees and the need to insure the wide currency of money and its substitutes. Accordingly, if the attorney legitimately viewed such payments as in the ordinary course, the attorney should be able to rely on these principles as a defense to a conversion action.²⁴⁷

b. *Exceptional cases.*

Two exceptional classes of cases should be addressed. These cases turn on more detailed principles of common law negotiability that are not fully developed above: the need for and the definition of value; and the meaning of due course.

i. Payment for executory promise—the meaning of value.

Suppose the debtor pays money that is collateral in exchange for an executory promise of property or services. For example, the debtor pays a retainer to an attorney as advance payment for promised representation. Like a holder in due course of a negotiable instrument, a bona fide purchaser of money takes free of claims only if she gives value in exchange. Whether or not the two principles share the same definition of value is uncertain; one could argue, however, that they do.²⁴⁸ If

247. Importantly, this emphasis on the attorney's perspective makes it inappropriate to rely in this context on cases like *In re Hanson Indus., Inc.*, 90 B.R. 405 (Bankr. D. Minn. 1988). In *Hanson*, the relevant issue was whether the debtor's attorney's fees paid during the gap period of an involuntary case were ordinary course expenses within the meaning of § 502(f). The bankruptcy court held that the fees stood outside the debtor's ordinary course of business, citing cases that had reached the same conclusion with respect to other rules, such as the "ordinary course" defense to the trustee's avoidance of a preference. *Id.* at 414; see 11 U.S.C. § 547(c)(2) (1988). *Hanson* and its supporting cases, however, are inapposite when applying the negotiability principle to attorneys, because they test ordinary course from the perspective of the debtor or third parties. Indeed, § 547(c)(2) expressly requires using the debtor's perspective. 11 U.S.C. § 547(c)(2)(B) (1988).

248. Notably, the innocence element may not necessarily be the same in both cases. Notice disqualifies a person from becoming a holder in due course of an instrument. In the case of money, however, only actual knowledge that a third party claims the specific funds disqualifies the recipient from holder in due course status. See, e.g., *Babcock v. Standish*, 33 A. 385, 387-88 (N.J. Eq. 1895) ("[M]oney has the quality of currency, passing from hand to hand in all bona fide transactions, without the necessity of inquiry on the part of him who receives it as to the title of the party who pays it. When property thus passes, the recipient may be put upon inquiry as to its title; when money thus passes, no inquiry is required. In the former case the knowledge which inquiry would produce would charge the recipient; in the latter case nothing but actual knowledge will charge him."); *Merchants' Loan & Trust Co. v. Lamson*, 90 Ill. App. 18, 21 (1899) ("[M]ere ground of suspicion of defect of title, or knowledge of circumstances which would excite such suspicion in the mind of a prudent man, or

so, the attorney would take the money free of the security interest only to the extent that she has performed the agreed consideration.²⁴⁹

gross negligence on the part of the taker, will not defeat title. Bad faith alone will defeat the right of the taker without knowledge. . . . Appellees are not shown to have had knowledge of the theft by which the moneys in question were obtained. At most it can be said that there were grounds of suspicion, or that they were guilty of some degree of negligence. No bad faith can be predicated upon these facts. They took the money in the due course of business").

Indeed, cases construing comment 2(c) itself have indicated that even knowledge is irrelevant. In *Harley-Davidson Motor Co., v. Bank of New England*, 897 F.2d 611, 622 (1st Cir. 1990), the court held that comment 2(c) would protect a junior creditor to whom the debtor paid proceeds of inventory even though this creditor knew that all of the debtor's inventory and its proceeds were subject to a prior perfected security interest. Other courts have held, however, that a recipient of money proceeds loses comment 2(c)'s protection if she takes the money with actual knowledge of a security interest in it, see *NCNB Tex. Nat'l Bank v. Standard Iron & Steel Co.*, No. 88-1726-K, 1990 WL 37929, at *2 (D. Kan. Mar. 16, 1990), or at least with knowledge that receipt of the proceeds violates the security agreement, see *FDIC v. World Univ., Inc.*, 978 F.2d 10, 15 (1st Cir. 1992); *Bank of Brewton v. General Motors Acceptance Corp.*, 811 F. Supp. 648, 651 (S.D. Ala. 1992); *Anderson, Clayton & Co. v. First Am. Bank*, 614 P.2d 1091, 1095 (Okla. 1980).

At the other extreme are cases such as *Brown & Williamson Tobacco Corp. v. First Nat'l Bank*, 504 F.2d 998, 1003 (7th Cir. 1974), where the court refused to apply comment 2(c) in favor of a bank partly because the bank had constructive notice of the security interest in the proceeds. Clearly, however, bona fide purchaser status with respect to money, whether in terms of comment 2(c) or otherwise, should not be denied on the basis of constructive notice supplied by a filed financing statement. Cf. U.C.C. § 3-302(b). But see *Farmers and Merchants Nat'l Bank v. Sooner Coop., Inc.*, 766 P.2d 325, 329 (Okla. 1988) (holding that where debtor paid proceeds of secured party's farm products collateral to a junior creditor, comment 2(c) did not protect creditor, because the secured party's filed financing statement covering crops and proceeds provided sufficient information to put the junior creditor on notice of the security interest).

It is possible that comment 2(c) accommodates all of these different tests of notice and makes no choice among them as an absolute rule. In construing comment 2(c), most courts approach the notice issue as part of the requirement that the debtor have transferred the proceeds in the ordinary course. The meaning of ordinary course is fact specific, turning on the context and circumstances of the case. The same can be true of notice as an element of ordinary course. The importance or unimportance of notice—even actual knowledge—may be relative, depending on the particular case.

249. See *Wheeler v. King*, 35 Hun. (N.Y.) 101 (1885) (allowing criminal defense lawyer to retain \$90 for services actually rendered out of \$150 retainer of stolen money in suit by true owner). For more recent cases, compare *Merchants State Bank v. Light*, 458 N.W.2d 792 (S.D. 1990) (per curiam) (awarding bank proceeds that debtor paid to lawyer for retainer) with *Lake Ontario Prod. Credit Ass'n v. Partnership of Grove*, 526 N.Y.S.2d 985 (N.Y. App. Div.), *appeal denied*, 529 N.E.2d 177 (1988) (holding that secured party could not recover proceeds from lawyer to whom the debtor had paid proceeds for legal services, which presumably had already been performed).

- ii. Payment setoff by depositary bank—out of the ordinary course.

Suppose that a debtor deposits money, which is a secured party's collateral, in a deposit account and the depositary bank sets off the account to satisfy a preexisting debt. When the right of setoff is subordinate to a security interest in the account, the bank may argue comment 2(c) and the common-law negotiability of money as an alternative basis for priority. The bank gave value, but the issue—in the terms of comment 2(c) and the common-law principle—is whether or not the setoff involved taking the money in the ordinary course. As noted earlier, good reason exists for defining "ordinary course" broadly,²⁵⁰ but even a broad definition should not include a bank's setoff of proceeds in a debtor's deposit account.²⁵¹ Indeed, the issue may be illusory

250. As explained in *Harley-Davidson Motor Co., v. Bank of New England*, 897 F.2d 611 (1st Cir. 1990), courts have liberally applied comment 2(c) and have not allowed the recovery of proceeds paid out of bank accounts except when the recipient's conduct was fraudulent or "at least seemed highly unfair or improper." *Id.* at 622. According to the *Harley Davidson* court, the reason is that: "If . . . courts too readily impose liability upon those who receive funds from the debtor's ordinary bank account — if, for example, they define ordinary course of business too narrowly — then ordinary suppliers, sellers of gas, electricity, tables, chairs, etc., might find themselves called upon to return ordinary payments . . . to a debtor's secured creditor, say a financier of inventory." *Id.*; see also *Stores West Corp. v. Exchange Nat'l Bank*, no. 84C10064, 1987 WL 5916 (N.D. Ill. Jan. 23, 1987) (requiring intent to undermine or circumvent the senior creditor's security interest as requisite to finding that money proceeds were taken other than in the ordinary course).

251. See, e.g., *Barber-Greene Co. v. National City Bank*, 816 F.2d 1267, 1271-72 (8th Cir. 1987) (holding that comment 2(c) was not intended to protect a bank in applying collateral account to the debtor's loan); *Brown & Williamson Tobacco Corp. v. First Nat'l Bank*, 504 F.2d 998, 1003 (7th Cir. 1974) (holding that setoff authorized by debtor—i.e., approved transfer by debit memo—was not in the ordinary course, especially because bank misrepresented debtor's account to the creditor whose proceeds were in the account and manipulated the account to the bank's own ends despite notice of the senior creditor's claim); *Universal C.I.T. Credit Corp. v. Farmers Bank*, 358 F. Supp. 317, 324 (E.D. Mo. 1973) (holding that bank's debit of debtor's account at debtor's request was not in the ordinary course when the debit occurred after business hours and in order to defeat checks drawn to secured party entitled to the proceeds in the account); *C&H Farm Serv. Co. v. Farmers Sav. Bank*, 449 N.W.2d 866, 876 (Iowa 1989) (finding bank's application of proceeds in account to satisfy overdrafts, which essentially amounted to a setoff, was not made in the ordinary course for purposes of comment 2(c)). But see *Stores West*, 1987 WL 5916, at *4 (stating that setoffs or scheduled debits from debtor's account were not extraordinary as a matter of law); *Tuloka Affiliates v. Security State Bank*, 627 P.2d 816, 820-21 (Kan. 1981) (holding that inventory financier lost priority in proceeds of inventory that debtor deposited in its bank account and that bank debited to satisfy loan to debtor on express authority of the debtor and without any fraud or collusion to defeat financier's security interest in the proceeds); *Anderson, Clayton &*

because the negotiability principle may be inapplicable in this case. The true issue may be the scope of an obligor's obligation against an assignee,²⁵² not the currency of money or instruments. In this event, the different, more specific, common-law rules of setoff properly govern the case so long as they have not been displaced by statute.

B. ATTORNEY-RECIPIENT'S DEFENSES TO VOIDABLE
PREFERENCE OR FRAUDULENT TRANSFER ATTACK

Typically, the principle of common-law negotiability or a derivative rule will protect attorney-recipients of proceeds from a secured party's conversion action. This protection, however, does not shield the recipients from the bankruptcy trustee's avoidance powers. For example, if a payment to a recipient meets the requirements of a preference under Bankruptcy Code section 547(b)²⁵³ and does not fall within a section 547(c) exception,²⁵⁴ the trustee may avoid and recover the payment under section 550(a)²⁵⁵ despite any principles of negotiability. A secured party who holds a security interest in the payment cannot directly use the trustee's avoidance powers to recover its collateral; but the secured party can argue that whatever the trustee recovers upon avoidance of the payment constitutes proceeds of the secured party's collateral and is therefore subject to the security interest.²⁵⁶ This scheme creates an indirect recovery for the secured party. In short, the secured party would receive the damages that the trustee recovers by avoiding someone else's interest in property—specifically, a transfer to an attorney-recipient of a payment representing the secured party's collateral.

In response to the use of such avoidance powers, the attorney-recipient can argue either that the Bankruptcy Code section on which the trustee relies is inapplicable or that she falls within an exception to the section at issue. More specifically, in the context of a section 547(b) preference attack the attorney-recipient will likely contend that the contemporaneous new

Co. v. First Am. Bank, 614 P.2d 1091, 1094 (Okla. 1980) (holding that bank will take proceeds free of security interest if debtor pays bank not by setoff, but by drafting against debtor's account at the bank and bank receives the payment in good faith and without knowledge that the receipt violated the security agreement).

252. See U.C.C. § 9-318(1).

253. 11 U.S.C. § 547(b) (1988) (elements of preference).

254. 11 U.S.C. § 547(c) (1988) (exceptions to preference).

255. 11 U.S.C. § 550(a) (1988) (liability of transferee of avoided transfer).

256. See *supra*, notes 183-192.

value exception of section 547(c)(1)²⁵⁷ or the ordinary payment of ordinary debts exception of section 547(c)(2)²⁵⁸ protects the payment to her. Alternatively, in the section 548 fraudulent transfer context, the attorney-recipient may rely on the section 548(c) exception to limit the trustee's recovery.²⁵⁹

1. Defenses to Voidable Preference Attack

A transfer constituting a preference under section 547(b) is nevertheless safe from avoidance by the trustee to the extent the transfer satisfies one or more exceptions described in section 547(c). According to one commentator, the exceptions in section 547(c):

are designed to rescue from attack in bankruptcy those kinds of transactions, otherwise fitting the definition of a preference, that are essential to commercial reality and do not offend the purposes of preference law, or that benefit the ongoing business by helping to keep the potential bankrupt afloat.²⁶⁰

a. *Contemporaneous new value exception.*

Section 547(c)(1) saves a preferential transfer made contemporaneously in exchange for new value.²⁶¹ Under section 547(c)(1), the trustee may not avoid a section 547(b) preference to the extent the transfer was:

(A) intended by the debtor and the creditor to or for whose benefit such transfer was made to be a contemporaneous exchange for new value given to the debtor; and

(B) in fact a substantially contemporaneous exchange.²⁶²

Four separate requirements must be met to satisfy this exception. First, the debtor must receive "new value." Second, the new value must be "in exchange" for the transfer. Third, that exchange must be "substantially contemporaneous." Finally, the parties must have "intended" a contemporaneous exchange.²⁶³

The new value exception is premised on the notion that a transfer made in exchange for new value, such as a cash sale of goods or payment for present services, does not offend the purposes behind preference law because the transaction does not re-

257. 11 U.S.C. § 547(c)(1) (1988).

258. 11 U.S.C. § 547(c)(2) (1988).

259. 11 U.S.C. § 548(c) (1988).

260. Orelup, *supra* note 126, at 233.

261. 11 U.S.C. § 547(c)(1) (1988).

262. *Id.*

263. 1 EPSTEIN, ET AL., *supra* note 122, at 588.

duce the debtor's estate to the detriment of her creditors. In a sense, the debtor simply substitutes one form of collateral or property for another: the services take the place of the payment. Indeed, one might argue that permitting the trustee to avoid such a payment contravenes the primary purpose of preference law, forestalling the debtor's slide into bankruptcy, because even "cash sellers would be discouraged from doing business with an unstable debtor because of the risk that an unintentional, minimal delay would turn an essentially cash transaction into an extension of credit accompanied by a voidable preference."²⁶⁴

As noted above, section 547(c)(1) requires that the debtor must have first received "new value." The Bankruptcy Code defines "new value" as follows:

[M]oney or money's worth in goods, services, or new credit, or release by a transferee of property previously transferred to such transferee in a transaction that is neither void nor voidable by the debtor or the trustee under any applicable law, including proceeds of such property, but does not include any obligation substituted for an existing obligation.²⁶⁵

Under this definition, paying an antecedent unsecured debt provides no new value. Thus, an attorney would be unable to rely on this section for payments received in conjunction with past services. Section 547(c)(1) would apply, however, if the services or the value the attorney provided the debtor actually and in real terms immediately "enhance[d] the worth of the debtor's estate so as to offset the reduction in the estate that the transfer caused."²⁶⁶ That is, if the attorney's services provided the debtor with some new tangible economic benefit.²⁶⁷

264. Orelup, *supra* note 126, at 234.

265. 11 U.S.C. § 547(a)(2) (1988). This definition is exclusive rather than suggestive. See *In re Energy Co-op, Inc.*, 832 F.2d 997, 1003 (7th Cir. 1987); *In re Hatfield Electric Co.*, 91 B.R. 782, 785 (Bankr. N.D. Ohio 1988). Nonetheless, the definition is somewhat pliable in combination with § 547(c)(1) to the extent that "section 547(c)(1) does not require that a contemporaneous exchange for new value involve the same type of consideration as that originally envisioned by the parties." *In re Lewellyn & Co.*, 929 F.2d 424, 429 (8th Cir. 1991) (holding that transfer of stock to securities broker-dealer in lieu of cash was new value for securities purchased within preceding seven days.).

266. 1 EPSTEIN, ET AL., *supra* note 122, at 592; see, e.g., *Hatfield Elec.*, 91 B.R. at 785; *In re White River Corp.*, 50 B.R. 403, 409 (Bankr. D. Colo. 1985), *affirmed*, 799 F.2d 631 (10th Cir. 1986); *In re Rustia*, 20 B.R. 131, 134 (Bankr. S.D.N.Y. 1982); *In re Duffy*, 3 B.R. 263, 266 (Bankr. S.D.N.Y. 1980).

267. See, e.g., *In re Fuel Oil Supply & Terminaling, Inc.*, 837 F.2d 224, 229-31 (5th Cir. 1988); *In re E.R. Fegert, Inc.*, 88 B.R. 258, 259 (Bankr. 9th Cir. 1988), *aff'd*, 887 F.2d 955 (9th Cir. 1989); *Hatfield Electric*, 91 B.R. at 786; cf. *In re Jet Florida Sys., Inc.*, 841 F.2d 1082, 1084 (11th Cir. 1988) ("new value" requires providing the debtor with a "material benefit"); *In re Nucorp Energy*,

Additionally, this exception applies only when the debtor makes the transfer in exchange for the new value. To satisfy this requirement, the exchange must be intended as, and actually be, an offsetting reciprocal; the debt must be created by the giving of new value. In the attorney-recipient scenario, therefore, the debtor's payment to an attorney for services rendered must actually be for new services rendered. The payment cannot be made to satisfy a preexisting obligation.²⁶⁸

Finally, section 547(c)(1) protects a transfer of the debtor's property in exchange for new value only if the parties intended the exchange to be contemporaneous and the exchange was actually "substantially contemporaneous."²⁶⁹ The intent requirement is a significant one. Section 547(c)(1) will not protect a payment even though the transfer satisfies its other requirements if the parties intended the payment for a past debt.²⁷⁰ Indeed, "without the requisite intent even a seven-hour gap between receipt of funds [or other value or services] and transfer of a security interest [or other property] [is] preferential [and be-

Inc., 80 B.R. 517, 519 (Bankr. S.D. Cal. 1987) ("the inquiry is whether the estate received something with economic value"); *In re George Rodman, Inc.*, 39 B.R. 855, 857 (Bankr. W.D. Okla. 1984) (New value essentially means "a transfer which has value in the economic sense.").

268. See, e.g., *In re Wadsworth Bldg. Components, Inc.*, 711 F.2d 122, 124 (9th Cir. 1983); *In re World Fin. Serv. Center, Inc.*, 78 B.R. 239, 241 (Bankr. 9th Cir. 1987); *In re Circleville Distrib. Co.*, 84 B.R. 502, 505 (Bankr. S.D. Ohio 1988); *In re Olympic Foundry Co.*, 51 B.R. 428, 430 (Bankr. W.D. Wash. 1985).

269. 11 U.S.C. § 547(c)(1)(B) (1988).

270. See, e.g., *Wadsworth Bldg. Components*, 711 F.2d at 124 (holding that § 547(c)(1) did not protect payment even where new value was thereafter given, because parties intended payment for past debt rather than for the new value given); *World Fin. Serv. Center*, 78 B.R. at 241-42 (finding contemporaneity lacking both in fact and by design); *In re Fasano/Harriss Pie Co.*, 71 B.R. 287, 289-90 (W.D. Mich. 1987) (stating that § 547(c)(1) not satisfied unless both creditor and debtor intended a contemporaneous exchange); *In re Jolly N, Inc.*, 122 B.R. 897, 904-05 (Bankr. D.N.J. 1991) (holding exception inapplicable because the transactions were purely credit transactions on a monthly billing schedule); *In re Advertising Assocs., Inc.*, 95 B.R. 849, 850 (Bankr. S.D. Fla. 1989) (refusing to consider whether lessor's forbearance was new value where parties did not intend the transfer to be in exchange for such forbearance); *In re Dakota Country Store Foods, Inc.*, 107 B.R. 977, 992-93 (Bankr. D.S.D. 1989) (holding that seller's repossession shortly followed by seller supplying goods was not protected by (c)(1) because the parties intended no contemporaneous exchange); *In re Trans Air, Inc.*, 78 B.R. 351, 355 (Bankr. S.D. Fla. 1987), *rev'd on other grounds*, 86 B.R. 290 (S.D. Fla. 1988) (finding no requisite intent and also no new value); Michael Kaye, *Preferences Under the New Bankruptcy Code*, 54 AM. BANKR. L.J. 197, 199 (1980); Raymond T. Nimmer, *Security Interests in Bankruptcy: An Overview of Section 547 of the Code*, 17 Hous. L. Rev. 289, 297 (1980).

yond the protection of § 547(c)(1)].²⁷¹

Importantly, “[i]ntent alone is not sufficient — the exchange must ‘in fact’ be contemporaneous in that there must be ‘temporal proximity between the [new value] and the [debtor’s] transfer.’”²⁷² Although the Bankruptcy Code does not define contemporaneous, and the issue of contemporaneity is very much a fact-bound inquiry that turns on each case’s peculiar facts and circumstances, courts have established some general benchmarks. Generally, a transfer of property involving a time period of greater than one month is not substantially contemporaneous²⁷³ but a transfer within a one week period is presumptively acceptable.²⁷⁴

In the instant case then, an attorney-recipient must demonstrate that both she and the debtor intended the payment to her to be for new services the attorney has recently provided or will soon provide. The payment for those services must be made within, at the most, one month after the attorney performs the services. If both criteria are met, an attorney-recipient may be able to argue that the new value exception protects her from the constraints of section 547(b).

b. *Ordinary course of business exception.*

Generally, a consumer debtor’s payment of a utility bill is a preference even though she makes the payment in due course. So too, is a debtor’s payment to her attorney for services rendered. Yet, in Congress’s view, these kinds of transfers, payments that are part of “normal financial [or business] relations”²⁷⁵ do not offend the objectives of section 547(b) as long as they meet the requirements of section 547(c)(2). Under section 547(c)(2), a trustee may not avoid a transfer that was:

(A) in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee;

271. Kaye, *supra* note 270, at 199. This warning is based on *National City Bank v. Hotchkiss*, 231 U.S. 50 (1913), the ultimate antecedent of the section 547(c)(1) “intent” requirement. In *Hotchkiss*, a debtor complied with a bank demand for collateral for an unsecured loan made earlier the same day. *Id.* at 55. The Court held that the pledge was a preference. *Id.*

272. *In re Montgomery*, 123 B.R. 801, 812 (Bankr. M.D. Tenn. 1991).

273. *In re Brown Family Farms, Inc.*, 80 B.R. 404, 412 (Bankr. N.D. Ohio 1987).

274. *Dean v. Davis*, 242 U.S. 438, 443 (1917) (Bankruptcy Act case).

275. H.R. REP. NO. 595, 95th Cong., 1st Sess. 373, *reprinted in* 1978 U.S.C.C.A.N. 5963, 6329; S. REP. NO. 989, 95th Cong., 2d Sess. 87, *reprinted in* U.S.C.C.A.N. 5787, 5874.

(B) made in the ordinary course of business or financial affairs of the debtor and the transferee; and

(C) made according to ordinary business terms.²⁷⁶

As should be apparent, section 547(c)(2) does not protect any payment by a debtor unless the circumstances surrounding the payment are "ordinary" in three different senses: the debtor must have incurred the debt toward which the payment was made in the ordinary course;²⁷⁷ the payment itself must have been made in the ordinary course;²⁷⁸ and the payment must have been made according to ordinary business terms.²⁷⁹ Applying the first requirement, courts have noted that section 547(c)(2) does not protect payments made toward a debt arising from a need or purpose, or out of a transaction, that is extraordinary for either the debtor or the transferee. In measuring the ordinariness of a transaction, courts have looked to what is ordinary for the parties involved.²⁸⁰ Thus, the debt itself must be ordinary in both directions. Incurring the obligation must be ordinary in the debtor's overall business or financial affairs,²⁸¹ and the right to payment that the debt creates in the transferee must be ordinary as to the transferee.

In the context of an attorney-recipient of fees, this first prong will be difficult to meet. An attorney can satisfy this first element only if she can establish that the payments made to her were those the debtor customarily made for legal services—i.e., pursuant to a long-standing attorney-client relationship with

276. 11 U.S.C. § 547(c)(2) (1988). "This exception codifies the 'current expense' rule under the old Act which protected wages and rent, and general operational expenses including advertising expenses, general business expenses, warehousing expenses, and payment of rent/tax arrearages to realize value of leasehold." Kaye, *supra* note 270 at 201-02.

277. 11 U.S.C. § 547(c)(2)(A) (1988).

278. 11 U.S.C. § 547(c)(2)(B) (1988).

279. 11 U.S.C. § 547(c)(2)(C) (1988).

280. See *In re Fulghum Const. Corp.*, 872 F.2d 709, 743 (6th Cir. 1989) (stating that courts must analyze "the business practices which were unique to the particular parties under consideration and not to the practices which generally prevailed in the industry of the parties").

281. See *In re Bishop, Baldwin, Rewald, Dillingham & Wong, Inc.*, 819 F.2d 214 (9th Cir. 1987); see also *In re Pittsburgh Cut Flower Co.*, 124 B.R. 451, 461 (Bankr. W.D. Pa. 1991) (holding the exception did not apply to debtor's payment for a partnership interest because the debt was incurred in order to extricate itself from an untenable position in which it had placed itself when the partnership was created); *In re Industrial & Mun. Eng'g, Inc.*, 127 B.R. 848, 850 (Bankr. C.D. Ill. 1990) ("The judgment was not incurred in the ordinary course of the Debtor's business. It was incurred to settle a lawsuit."). It is entirely possible, however, that "a transaction can be in the ordinary course of financial affairs even if it is the first such transaction undertaken by the customer." *In re Finn*, 909 F.2d 903, 908 (6th Cir. 1990).

the debtor. The attorney-recipient will not likely satisfy this first prong where the debtor hired her only as bankruptcy counsel, because the bankruptcy, and thus hiring an attorney for that purpose, will likely be an extraordinary event for that debtor. Indeed, courts are likely to construe such payments as a preference and treat them analogously to cases that have not spared a debtor's settlement payments based on ordinary trade debts from avoidance as a preference under section 547(c)(2).²⁸²

Even if the attorney-recipient succeeds in establishing that the debt was incurred in the ordinary course, to avail herself of section 547(c)(2)'s protections, she must still demonstrate that the debtor made the payments to her in the ordinary course and on ordinary business terms. In other words, the payment must be ordinary when compared with the overall financial routine of the debtor and the transferee. As courts have noted in this regard, a payment is extraordinary and beyond the protection of (c)(2), if the payment is associated with any "variation from what theretofore had been the usual course of dealing" between the parties²⁸³—i.e., if the payment is untimely,²⁸⁴ unless un-

282. See, e.g., *In re Energy Co-op, Inc.*, 832 F.2d 997, 1004 (7th Cir. 1987); *Hickey v. Nightingale Roofing, Inc.*, 83 B.R. 180, 183-84 (D. Mass. 1988); *In re Gull Air, Inc.*, 82 B.R. 1 (Bankr. D. Mass. 1988); *In re Red Way Cartage Co.*, 84 B.R. 459 (Bankr. E.D. Mich. 1988); *In re Richardson*, 94 B.R. 56, 60 (Bankr. E.D. Pa. 1988); see also *Energy Co-op, Inc.*, 832 F.2d at 1005 (holding that evidence failed to establish that debtor normally breached contracts and then paid settlements); *Hickey*, 83 B.R. at 181 ("it requires an extraordinarily latitudinarian reading of the term 'ordinary' . . . to treat litigation settlements as other than clearly not 'ordinary'"). But see *In re Gilbertson*, 90 B.R. 1006, 1010-12 (Bankr. D.N.D. 1988) (holding that payment pursuant to debt restructuring agreement was shielded by § 547(c)(2) where such agreements were common in the industry and this agreement had been entered into six months before the contested payment); *In re Magic Circle Energy Corp.*, 64 B.R. 269, 273 (Bankr. W.D. Okla. 1986) (finding payments over two years pursuant to a workout agreement protected by (c)(2)); *id.* at 273 ("the mere restructuring of the payment terms does not alter the fact that the underlying debt was incurred under normal circumstances").

283. *In re Singer Prods. Co.*, 102 B.R. 912, 935 (Bankr. E.D.N.Y. 1989).

284. See e.g., *In re Xonics Imaging, Inc.*, 837 F.2d 763, 764 (7th Cir. 1988) (regarding late rental payments); *In re Federated Mktg., Inc.*, 123 B.R. 265, 270 (Bankr. S.D. Ohio 1991) ("[T]he delinquency of the Debtor's payments [paying invoices 79 to 101 days old] constituted an exception to the parties' course of dealings and not the norm, and therefore, these two transactions were not made in the ordinary course of business."); *In re Hancock-Nelson Mercantile Co.*, 122 B.R. 1006, 1009-15 (Bankr. D. Minn. 1991) (finding payments made 14 to 30 days after invoice were extraordinary and beyond § 547(c)(2) because, usually, payments had been made on delivery or net weekly.); *In re Cook United, Inc.*, 117 B.R. 884, 888 (Bankr. N.D. Ohio 1990) (holding late utility payments were extraordinary because payments were usually made on time); *In re Homes of Port Charlotte, Florida, Inc.*, 109 B.R. 489, 491 (Bankr. M.D. Fla. 1990) (stating

timely payments are customary in the relationship between the debtor and the transferee.²⁸⁵ Moreover, the payments must be

payments are not in the ordinary course that are made beyond the parties' normal payment interval); *In re Global Distrib. Network, Inc.*, 103 B.R. 949, 950 (Bankr. N.D. Ill. 1989) (holding checks to suppliers paid from 75 to 127 days after the invoice dates were not in ordinary course); *In re Writing Sales Ltd. Partnership*, 96 B.R. 179, 181 (Bankr. E.D. Wis. 1989) (paying invoices from 72 to 130 days after issuance was preferential where average time of payment was 58 days); *In re Aldridge*, 94 B.R. 589, 593 (Bankr. W.D. Mo. 1988) ("A late payment may be considered within the ordinary course of business under certain circumstances. However, untimely payments are more likely to be considered outside the ordinary course of business."); *In re Circleville Distrib. Co.*, 84 B.R. 502, 502-03 (Bankr. S.D. Ohio 1988) (finding payment of arrearage for services during preference period not in ordinary course); *In re First Software Corp.*, 84 B.R. 278, 281 (Bankr. D. Mass. 1988) (holding arrearage for accounts arising from sales of goods beyond ordinary course); *In re Ramco/Fitzsimons Steel Co.*, 95 B.R. 299, 300-01 (Bankr. W.D.N.Y. 1988) (holding payments to supplier made 70 to 90 days after shipment were well beyond both the contract time of 30 days and the generally allowed late period of 45 to 60 days); *In re Red Way Cartage Co.*, 84 B.R. 459, 461 (Bankr. E.D. Mich. 1988) (holding that payment of note that evidenced obligation for back rent was not in ordinary course); *In re Websco, Inc.*, 92 B.R. 1, 3 (Bankr. D. Me. 1988) (denying section 572(c)(2) protection to payments made on past due accounts in an attempt to clear outstanding balance); *In re Air One, Inc.*, 80 B.R. 145, 147-48 (Bankr. E.D. Mo. 1987) (finding that installment payments on invoice paid beyond 30-day billing cycle were not in ordinary course); *In re Bob Grissett Golf Shoppes, Inc.*, 78 B.R. 787, 788 (Bankr. E.D. Va. 1987) (holding payments made to satisfy large arrearage owed for previous shipments of goods not protected by § 547(c)(2)); *In re Southern Commodity Corp.*, 78 B.R. 626, 628 (Bankr. S.D. Fla. 1987) (finding payments made between February and May for invoices dated from October to January were not ordinary); *In re Sweetapple Plastics, Inc.*, 77 B.R. 304, 306 (Bankr. M.D. Ga. 1987) (holding delinquent partial payment unprotected); *In re Van Huffel Tube Corp.*, 74 B.R. 579, 588 (Bankr. N.D. Ohio 1987) (finding payments for invoices that were 150 days old, though terms required payment in 30 days, not ordinary).

285. See, e.g., *Lovett v. St. Johnsbury Trucking*, 931 F.2d 494, 497-99 (8th Cir. 1991) (holding debtor's payments to creditor that were consistently made late fell within § 547(c)(2) because the ordinary course of business was the way the parties actually conducted their business dealings, not the way described in their agreement.); *In re Yurika Foods Corp.*, 888 F.2d 42, 44-45 (6th Cir. 1989) ("Normally [and in this case], if late payments were the standard course of dealing between the parties, they shall be considered as within the ordinary course of business under § 547(c)(2)."); *In re Xonics Imaging, Inc.*, 837 F.2d 763, 766 (7th Cir. 1988) (stating late payments may be ordinary between parties if there is a custom of such payments between them) (dicta); *In re Classic Drywall, Inc.*, 121 B.R. 69, 75-79 (D. Kan. 1990) (noting the ordinary business exception covers ordinary late payments even if the billing statements expressly provided time of payment); *First Software Corp. v. Micro Educ. Corp.*, 103 B.R. 359, 360-61 (D. Mass. 1988) (holding invoices paid after due dates pursuant to oral agreement for weekly payments, as parties had done at least on one other occasion in the past within ordinary course); *In re Atlantic Fish Mkt., Inc.*, 100 B.R. 755, 756-57 (Bankr. E.D. Pa. 1989) (finding payments made well beyond the time specified in the invoice deemed ordinary because the debtor usually paid

made according to ordinary business terms. The mechanics of

the creditor late); *In re Excello Press, Inc.*, 96 B.R. 840, 843-44 (Bankr. N.D. Ill. 1989) (stating that extra-contractual practice of late payments may become the ordinary course of business between the parties); *In re Gardner Matthews Plantation Co.*, 118 B.R. 384, 386-87 (Bankr. D.S.C. 1989) (holding that late payments were ordinary because lateness was routine); *In re Matters*, 99 B.R. 314, 316-17 (Bankr. W.D. Va. 1989) (finding that late payment was ordinary as consistent with debtor's history of late payments and not made in response to any pressure); *In re Service Bolt & Nut Co.*, 97 B.R. 892, 895 (Bankr. N.D. Ohio 1989) (holding late payments made during preference period protected because the parties consensually chose to ignore contract's payment terms and instead engaged in a late payment mode); *In re First Software Corp.*, 81 B.R. 211, 214 (Bankr. D. Mass. 1988) (stating that late payment of invoices ordinary given creditor's tolerance for long delays); *In re Jerry-Sue Fashions, Inc.*, 91 B.R. 1006, 1008 (Bankr. S.D. Fla. 1988) (holding that parties established course of dealing that allowed debtor to exceed 30-day payment terms); *In re Jerry-Sue Fashions, Inc.*, 89 B.R. 995 (Bankr. S.D. Fla. 1988) (allowing invoices paid by installments); *In re Sims Office Supply, Inc.*, 94 B.R. 744, 747 (Bankr. M.D. Fla. 1988) (finding that payments after due date, that were consistent with parties custom, not extraordinary); cf. *In re Zwagerman*, 125 B.R. 486, 492-93 (W.D. Mich. 1991) (holding payments were ordinary that were later and later because this pattern existed over a period of time in the parties' relationship and that irregular payments are ordinary if they are consistent with the parties' dealings); *In re National Office Prod., Inc.*, 119 B.R. 896, 897 (Bankr. D.R.I. 1990) (finding erratic payments ordinary in case in which the parties never established a regular payment pattern); *In re First Software Corp.*, 85 B.R. 669, 672 (Bankr. D. Mass. 1988) (holding payment made late but earlier than usual late payment not extraordinary); *In re Southern Indus. Banking Corp.*, 92 B.R. 297, 305 (Bankr. E.D. Tenn. 1988) (finding withdrawals from thrift institution that failed to satisfy technical, formal requirements governing depositors' accounts not necessarily out of the ordinary if the transactions were consistent with other transactions between the parties).

The exception to the rule does not apply, however, if the debtor's late payments—though routine—were made after the creditor stopped tolerating the payment delays and engaged in unusual debt collection practices, such as terminating the contract with the debtor and demanding payment of all sums due. See *In re Seawinds Ltd.*, 91 B.R. 88 (N.D. Cal. 1988), *aff'd* 888 F.2d 640 (9th Cir. 1989); see also *In re Miniscribe Corp.*, 123 B.R. 86, 93-95 (Bankr. D. Colo. 1991) (holding payments that were more timely during the preference period than before the period were not in the ordinary course because the creditor "used its leverage as a singular supplier of critical parts to insure it received payments on outstanding invoices.").

The exception is also inapplicable if the payments are delayed beyond the parties' normal payment interval. See, e.g., *In re Century Brass Prod., Inc.*, 121 B.R. 136, 138-39 (Bankr. D. Conn. 1990) ("These payments were between 120 and 149 days, or an average of 134 days, after invoice date, when the average delay in prior years never exceeded 85 days."); *In re Homes of Port Charlotte, Florida, Inc.*, 109 B.R. 489, 491 (Bankr. M.D. Fla. 1990) (finding payments made later than usual during preference period are not in the ordinary course); *Samar Fashions, Inc. v. Private Line, Inc.*, 116 B.R. 417, 420 (E.D. Pa. 1990) (same).

payment must be in the ordinary course of business.²⁸⁶

The attorney-recipient of fees will likely be able to satisfy these last two criteria easily. As long as the attorney-recipient can demonstrate that the debtor made the payments to her in the usual course of dealing between the parties, she will satisfy the former criteria. Furthermore, if she can show that the mechanics of the payments were ordinary, she will satisfy the latter requirement.

2. Defenses to Fraudulent Transfer Attack

If a transfer to the attorney-recipient is voidable under section 548(a), the attorney may be able to rely on section 548(c) to limit the trustee's recovery.²⁸⁷ Section 548(c) provides:

[A] transferee or obligee of such a transfer or obligation that takes for value and in good faith has a lien on or may retain any interest transferred or may enforce any obligation incurred, as the case may be, to the extent that such transferee or obligee gave value to the debtor in exchange for such transfer or obligation.²⁸⁸

Section 548(c) provides a *pro tanto* defense; it allows a transferee to avoid a trustee's recovery only to the extent of the value the transferee provided. The transferee forfeits any value in the property exceeding what she paid for it.

Central to the operation of section 548(c), however, is the "good faith" requirement, an "indispensable element" of this saving provision.²⁸⁹ Although good faith "is not susceptible of precise definition,"²⁹⁰ courts have generally held that good faith requires an arm's length transaction²⁹¹ in which the transferee herself acts honestly and without malice or fraudulent design.²⁹²

286. For a discussion regarding the subjective-objective nature of these two criteria, see 1 EPSTEIN, ET AL., *supra*, note 122, at 617-20.

287. 11 U.S.C. § 548(c) (1988).

288. *Id.*

289. *In re Roco Corp.*, 701 F.2d 978, 984 (1st Cir. 1983); *see also In re Candor Diamond Corp.*, 76 B.R. 342, 351 (Bankr. S.D.N.Y. 1987).

290. *Roco Corp.*, 701 F.2d at 984.

291. *In re Independent Clearing House Co.*, 77 B.R. 843, 862 (D. Utah 1987); *see also Kidder Skis Int'l v. Williams*, 60 B.R. 808, 809-10 (W.D. Mo. 1985) (finding lack of good faith based partly on defendant having closer financial relationship with debtor than did other creditors); *In re Baker & Getty Fin. Serv., Inc.*, 98 B.R. 300, 309 (Bankr. N.D. Ohio 1989) (holding test for "good faith" under § 548(c) is whether the transaction is at arm's length, which is not satisfied when the transferee's president had a personal interest at stake in the transfer).

292. *In re Cole*, 81 B.R. 326, 328, *further opinion*, 89 B.R. 433 (Bankr. E.D. Pa.), *order amended*, 89 B.R. 433 (Bankr. E.D. Pa. 1988). Good faith is not lack-

Hence, when the bankruptcy trustee avoids an attorney's payments under section 548(a), the attorney can invoke section 548(c)'s protections to the extent of the value she actually provided the debtor. So, if the court determines that the attorney's availability for services (and that this was not an unperformed promise having no value under section 548(d)(2)(A)) was worth \$5,000 to the debtor, and not the \$20,000 the debtor actually paid, then the court will award the attorney a lien on the property (the \$20,000 she is compelled to return to the estate under section 548(a)) to the extent of such value: \$5,000.²⁹³

The only difficulty the attorney may face in the use of section 548(c) is the good faith requirement. Courts have usually found that good faith is lacking under section 548(c) if the transferee knew at the time of the transfer, that the debtor was insolvent²⁹⁴ or in financial difficulty.²⁹⁵ Courts have gone so far as to

ing, however, simply because the transferee receives a good bargain in her dealings with the debtor. *In re Independent Clearing House Co.*, 77 B.R. 843, 862 (D. Utah 1987).

293. See *In re Barrett*, 104 B.R. 688, 694-95 (Bankr. E.D. Pa. 1989), *order vacated on other grounds*, 111 B.R. 78 (E.D. Pa. 1990), *on remand*, 113 B.R. 175 (Bankr. E.D. Pa. 1990), *decision rev'd*, 111 B.R. 255 (E.D. Pa. 1990), *judgment aff'd*, 939 F.2d 20 (3d Cir. 1991) (holding transferee of avoided sheriff's sale entitled to § 548(c) lien); *In re Ananko*, 89 B.R. 399, 407-08 (Bankr. D.N.J. 1988), *cause remanded*, 91 B.R. 231 (D.N.J. 1988) (noting that purchaser at avoided sheriff's sale gets lien on the property to the extent of consideration paid) (dicta); *In re Stuples*, 87 B.R. 645, 646 (Bankr. D. Or. 1988) (stating that when trustee avoids a mortgage foreclosure sale, good faith buyer gets a lien to the extent of value given) (dicta).

294. *Independent Clearing House*, 77 B.R. at 861-62 (dicta); see *In re Anchorage Marina, Inc.*, 93 B.R. 686, 693 (Bankr. D.N.D. 1988) ("Transferees are not acting in good faith when they have knowledge sufficient to put them on at least inquiry notice of the debtor's possible insolvency."); *In re Health Gourmet, Inc.*, 29 B.R. 673, 677 (Bankr. D. Mass. 1983) ("The [transferee-] lender's knowledge of the [debtor-] borrower's insolvency prohibits a finding that he is a good faith transferee.")

295. *In re Energy Sav. Center, Inc.*, 61 B.R. 732, 736 n.4 (E.D. Pa. 1986) (good faith requires lack of knowledge of any circumstance placing the transferee on notice of the transferor's financial condition) (dicta); *Kidder Skis Int'l v. Williams*, 60 B.R. 808, 809-10 (W.D. Mo. 1985) (finding lack of good faith based partly on transferee's knowledge of debtor's financial trouble); *In re Jacobs*, 60 B.R. 811, 815 (M.D. Pa. 1985), *judgment aff'd*, 802 F.2d 446 (3d Cir. 1986) (holding transferee not entitled to § 548(c) exception because knew debtors' precarious financial condition at the time of the transfers); *In re Fitzpatrick*, 73 B.R. 655, 658 (Bankr. W.D. Mo. 1985), *rev'd in part on other grounds*, 60 B.R. 808 (W.D. Mo. 1985) (denying defendant § 548(c) lien because he knew or should have known of debtor's financial distress); *In re Polar Chips Int'l, Inc.*, 18 B.R. 480, 484 (Bankr. S.D. Fla. 1982) (finding transferee lacked good faith due to knowledge of debtor's "precarious finances"). *But cf. In re Practical Inv. Corp.*, 95 B.R. 935, 944 n.6, 945 (Bankr. E.D. Va. 1989) (finding that loaning debtor money, in exchange for security, is not bad faith, even if the lender-transferee

charge a transferee not only with her actual knowledge of a debtor's difficulties, but also with any knowledge that a reasonable person in her position would have possessed.²⁹⁶

Here, because the debtor hires the attorney specifically to deal with its financial distress, the attorney is *per se* aware of it and the trustee may attack the attorney's use of section 548(c) for a lack of good faith. Faced with this attack, the attorney-recipient's most credible response might be to argue that her situation is not the one the good faith requirement countenances. She might contend that, ordinarily, knowledge of a debtor's insolvency or financial distress is problematic because it suggests an awareness that the transfer would be detrimental to the debtor's creditors.²⁹⁷ Yet, in her situation, the attorney does not seek to benefit at the expense of the debtor's creditors but merely to provide a much needed service to the debtor—a service which, as will be developed later in this Article, may actually benefit the debtor's creditors by ensuring the smooth administration of the bankruptcy estate and thereby reducing bankruptcy costs.

knows that the debtor is having financial difficulties, if the lender believed that its loan would be used to satisfy what appeared to be the debtor's only creditors); *In re Laughlin*, 18 B.R. 778, 780-81 & 780 n.3 (Bankr. W.D. Mo. 1982) (stating that knowledge that debtor was broke does not deny subsequent transferee benefit of § 548(c) in absence of notice respecting the voidability of the debtor's transfer).

296. *In re Anchorage Marina, Inc.*, 93 B.R. 686, 693 (Bankr. D.N.D. 1988) ("Transferees are not acting in good faith when they have knowledge sufficient to put them on at least inquiry notice of the debtor's possible insolvency."); *In re Fitzpatrick*, 73 B.R. 655, 658 (Bankr. W.D. Mo.), *rev'd in part on other grounds*, 60 B.R. 808 (W.D. Mo. 1985) (denying defendant § 548(c) lien because he knew or should have known of debtor's financial distress); *In re Polar Chips Int'l, Inc.*, 18 B.R. 480, 484 (Bankr. S.D. Fla. 1982) (stating that a transferee lacks good faith "[I]f the circumstances of a conveyance are such as to put an ordinary prudent man on inquiry as to the fraudulent purpose of the debtor, and if a diligent inquiry would have discovered the fraudulent purpose, and the transferee fails to make such an inquiry . . ."). *But cf. In re Independent Clearing House Co.*, 77 B.R. 843, 862 (D. Utah 1987) (stating that good faith is a subjective question on which summary disposition is usually inappropriate).

297. *See In re Health Gourmet, Inc.*, 29 B.R. 673, 677 (Bankr. D. Mass. 1983) ("The [transferee-] lender's knowledge of the [debtor-] borrower's insolvency prohibits a finding that he is a good faith transferee," because the lender would know that the transaction would be detrimental to the debtor's other creditors.); *Polar Chips Int'l*, 18 B.R. at 484 (holding transferee lacked good faith due to knowledge of debtor's "precarious finances" and other circumstances "which made it apparent . . . that the effect of the transaction [was] to defraud the [debtor's] creditors").

IV. THE SECURED PARTY'S LIABILITY FOR THE COST OF BANKRUPTCY; SECTION 506 AND GAME THEORY

As previously discussed, if the money that the debtor uses to pay prepetition attorneys' fees is secured collateral, the attorney is *prima facie* liable to the secured party for conversion. The common law principle of negotiability or a derivative rule will likely protect the attorney in this instance, however. Yet, the negotiability principle only protects the attorney from the secured party's conversion claim. It does not protect her against the trustee's exercise of her avoidance powers. Nor does it prevent the recovery of an excessive payment under a bankruptcy court's section 329 power to scrutinize and regulate prepetition attorney compensation.

Of course, to the extent that the debtor's lawyer has a security interest in the retainer, the property is her collateral, with respect to which she herself is a secured creditor. Nevertheless, the lawyer's secured claim is usually inferior to an earlier perfected security interest of another creditor who traces the retainer to collateral or proceeds. Typically, the creditor perfects the earlier interest by filing.²⁹⁸ The perfection automatically continues in the money,²⁹⁹ and relates back to the time the creditor perfected the security interest in the original collateral.³⁰⁰ Therefore, the other creditor wins under the familiar priority rule that governs disputes between Article 9 secured parties: the first to file or perfect prevails.³⁰¹

Nothing in the Bankruptcy Code reliably trumps the other creditor's usual Article 9 priority.³⁰² The attorney's only hope is that the senior secured party will consensually subordinate its interest, as often happens in a cash-collateral agreement.³⁰³ In this event, the attorney's priority falls entirely within the senior

298. See U.C.C. §§ 9-302(1), 9-401 & 9-402.

299. U.C.C. § 9-306(3)(b).

300. U.C.C. § 9-312(6).

301. U.C.C. § 9-312(5).

302. Not even a § 364(d) superpriority lien would trump the creditor's priority. It would simply be transferred to some other priority because of the adequate protection requirement.

303. An attorney may bring a motion for authorization to use cash collateral. 11 U.S.C. § 363(c)(2)(B) (1988). See, e.g., *In re Tri-County Water Ass'n, Inc.*, 91 B.R. 547, 550 (Bankr. S.D. 1988); *In re Fleeman*, 73 B.R. 579 (Bankr. M.D. Ga. 1987); *In re Sheehan*, 38 B.R. 859 (Bankr. D.S.D. 1984); *In re Georgia Steel, Inc.*, 19 B.R. 834 (Bankr. M.D. Ga. 1982). Of course, such authorization triggers the secured creditor's right to have its interest adequately protected. 11 U.S.C. § 363(c) (1988).

secured creditor's control. The attorney's priority will exist only by and to the extent of the other creditor's consent.

In the case of postpetition attorneys' fees, courts ordinarily treat such fees as administrative expenses.³⁰⁴ The bankruptcy court can review and approve such fees³⁰⁵ but cannot give them a higher priority than the Bankruptcy Code prescribes³⁰⁶ or pay them from a secured party's collateral.³⁰⁷ Even in Chapter 11 cases in which paying professional fees is a "favored object,"³⁰⁸ doing so:

is no more favored than protecting the rights of creditors with secured claims. As a general rule, expenses of administration must be satisfied from assets of the estate not subject to liens. A secured creditor's interest in its collateral is a substantive property right created by nonbankruptcy law which may not be substantially impaired when bankruptcy intervenes. Generally, the only valid liens that are subordinated to administration expenses are tax liens and ERISA liens. A secured creditor is not to be deprived of the benefit of its bargain and will be protected in bankruptcy to the extent of the value of its collateral. Only surplus proceeds are available for distribution to creditors of the estate and administrative claims. Therefore, absent equity in the collateral, administrative claimants [including the debtor's lawyers] cannot look to encumbered property to provide a source of payment for their claims.³⁰⁹

Moreover, the bankruptcy court cannot invoke its equitable powers under section 105³¹⁰ to ignore these limitations on payment because "whatever equitable powers [are retained by] bankruptcy courts . . . can only be exercised within the confines of the

304. 11 U.S.C. §§ 503(b)(2), 507(a) (1988).

305. 11 U.S.C. § 330(a) (1988).

306. Superseding chapter 7 expenses, for example, are paid before legal fees incurred during the former chapter 11. See *In re Davison*, 95 B.R. 665, 666 (Bankr. W.D. Mo. 1988); *In re Crisp*, 92 B.R. 885, 889-90 (Bankr. W.D., Mo. 1988). Also, super-priority administrative expenses under § 364(c)(1) must be paid before the debtor's lawyer's fees. See *State Bank v. Bisgard*, 80 B.R. 491, 494-95 (D.S.D. 1987); *In re American Resources Management Corp.*, 51 B.R. 713, 717-20 (Bankr. D. Utah 1985); *In re Mobile Air Drilling Co., Inc.*, 53 B.R. 605, 609 (Bankr. D. Ohio 1985).

307. See, e.g., *In re Jefferson Business Center Assocs.*, 135 B.R. 676 (Bankr. D. Colo. 1992); *In re KNM Poswell Ltd. Partnership*, 126 B.R. 548 (Bankr. N.D. Ill. 1991); *In re Tri-County Water Ass'n, Inc.*, 91 B.R. 547 (Bankr. D.S.D. 1988); *In re Roamer Linen Supply, Inc.*, 30 B.R. 932 (Bankr. S.D.N.Y. 1983); cf. *American Resources Management*, 51 B.R. at 719 (regarding fees for professionals hired by trustee and creditors' committee). But see *In re Hall Nestletree II Associates*, 112 B.R. 201 (Bankr. S.D. Tex. 1989).

308. *American Resources Management*, 51 B.R. at 719; see also *Tri-County Water Ass'n*, 91 B.R. at 549.

309. *American Resources Management*, 51 B.R. at 719 (citations omitted).

310. 11 U.S.C. § 105(a) (1988).

Bankruptcy Code."³¹¹

The classification of attorneys' fees as second-tier administrative expenses means that an attorney will not be paid for its bankruptcy services if all the debtor's collateral is encumbered unless either the secured parties enter into a cash collateral agreement by which they consent to the payment of attorneys' fees or the bankruptcy trustee, as the representative of the general creditors, including the attorney, can minimize the amount of the bankrupt's secured debt. The trustee can minimize the estate's secured debt in two ways. First, the trustee can exercise her avoidance powers under the Bankruptcy Code.³¹² In addition, if the secured creditor must be allowed to realize her security interest, the trustee can minimize the impact on the general estate, and hence on its attorneys, by charging as much of the cost of the bankruptcy proceeding, including attorneys' fees, against the secured creditor's interest, for these costs must be paid before the trustee makes any distributions to general creditors.³¹³ This latter method of minimizing the amount of secured creditor claims raises the central issue: to what extent is the secured creditor responsible for the costs and expenses incurred during the bankruptcy. This section contends that, pursuant to section 506(c) of the Bankruptcy Code, attorneys' fees that benefit the secured party should be charged to that party.

A. COSTS UNDER THE BANKRUPTCY ACT

The Bankruptcy Act left unclear which party was responsible for costs and expenses incurred during bankruptcy. As one leading treatise observed:

[H]ardly any phase of the bankruptcy law has been plagued with so many inconsistent generalities, irreconcilable rules and principles disagreements between circuits and even within circuits (apparently without any awareness thereof) and loose, indiscriminate statements of rules and citations of authority.³¹⁴

To settle this issue, courts considered four independent theories based on: the benefit to the secured creditor; the secured party's consent to the sale free of liens; the analogous cost of foreclosing

311. *Norwest Bank v. Ahlers*, 485 U.S. 197, 206 (1988).

312. See 11 U.S.C. §§ 544, 545, 547, 548, 549.

313. See 11 U.S.C. §§ 727, 1129.

314. WILLIAM J. COLLIER, 4B COLLIER ON BANKRUPTCY ¶70.99[6], at 1224-25 (James W. Moore et al. eds., 14th ed., Matthew-Bender 1978); see also J. Hobson Presley, Jr., Note, *The Cost of Realization by a Secured Creditor in Bankruptcy*, 28 VAND. L. REV. 1091 (1975) (surveying the state of pre-Code law in this area).

outside of bankruptcy; and the existence of a surplus in the proceeds of secured collateral.³¹⁵

Under the benefit to the secured creditor theory, courts presumed that the secured creditor should not be charged with the expenses of bankruptcy administration unless the trustee incurred these costs to protect or preserve the secured collateral. In that case, the courts maintained that the secured creditor should pay the administrative expenses only to the extent she benefitted therefrom.³¹⁶ As one court noted:

A lienholder normally should not be charged with administrative expenses. However, where expenses are incurred that primarily benefit the lienholder such expenses should be allocated to him in the proportion to the benefit he derives therefrom. When a lienholder alone derives the benefit then he alone should bear the expense. To hold otherwise would be to compel general creditors to pay costs and expenses not incurred for their benefit but solely for the benefit of a third person.³¹⁷

These courts based their view on the equitable principle that charges should be levied only against those who have derived a primary benefit from them. They also relied on the equitable doctrine of unjust enrichment which, applied in this context, holds that a secured creditor should not receive a windfall when expenditures by the bankruptcy court, including attorneys' fees,³¹⁸ led to realization on her lien when she would have otherwise had to bear the expense of foreclosure in another forum.³¹⁹

As one commentator noted, however, the benefit to the secured creditor theory suffers from a number of drawbacks.³²⁰ Foremost, it is often difficult to determine what costs actually benefit the secured creditor. In addition, the courts provided no guidance regarding who was to bear the burden of showing which costs, and what portions thereof, were for the benefit of secured parties. Related to these problems was the fact that trustees often refused to release collateral because they hoped to defeat secured claims or obtain equity for the general creditors.

315. See Leigh H. Savage, *The Secured Claimholder's Liability for the Costs and Expenses Incurred in Bankruptcy*, 90 COM. L. J. 430, 431 (October 1985); Presley, *supra* note 314, at 1098.

316. *Dreyfuss v. Klein (In re Tyne)*, 257 F.2d 310, 312 (7th Cir. 1958); *In re Cheyenne Wells Elevator Corp.*, 266 F. Supp. 927, 929 (D. Colo. 1967); *In re Louisville Storage Co.*, 21 F. Supp. 897 (W.D. Ky. 1936); *In re Rice Leghorn Farm*, 113 F. Supp. 903, 906 (W.D. Mo. 1953); *United States v. Henderson*, 274 F.2d 419, 422-23 (5th Cir. 1959).

317. *Dreyfuss*, 257 F.2d at 312.

318. *Id.*

319. Presley, *supra* note 314, at 1098-99.

320. *Id.* at 1099-1102.

In this situation, secured creditors contended and courts found³²¹ that because the trustee truly incurred these expenses for the benefit of the general creditors it was only fair for the general creditors to bear these expenses.

Pursuant to the second theory, courts considered the secured party's consent as the primary consideration in determining whether, and to what extent, they should assess costs of the bankruptcy against the secured creditor. As these courts reasoned, when a secured creditor expressly or impliedly consented to the sale of secured collateral, free and clear of liens, she should be liable for the costs of the sale, the preservation and protection of the assets, and a proportional share of the bankruptcy's general administrative expenses.³²² The basic rationale underlying the consent theory was the notion that if a secured creditor wished to avoid the expenses of bankruptcy, she could effect her foreclosure elsewhere; if, however, she willingly resorted to bankruptcy court she could not be heard to complain of any costs that were subsequently incurred.³²³

The consent theory likewise posed several problems. First, a secured creditor's consent to a sale free of liens meant nothing if the trustee had already decided to sell free and clear of liens; a secured creditor's consent was only pertinent when she affirmatively requested that a sale take place.³²⁴ Only when the secured creditor had actually imposed on the bankruptcy court the burden of foreclosing on the lien, was it equitable that the secured creditor bear the expenses normally or necessarily incurred in the course of those proceedings. In addition, courts varied greatly in their determination of whether or not a secured party actually consented. Several courts held that acquiescence in, or failure to object to, the sale free of liens sufficed to show consent.³²⁵ Alternatively, other courts held that the fact that the secured creditor did not "ask for" the services of the bankruptcy court in foreclosing was equivalent to non-consent.³²⁶ Finally, if consent given to a sale encompassed all expenses

321. See *In re Pioneer Sample Book Co.*, 374 F.2d 953 (3d Cir. 1967); *In re Street*, 184 F.2d 710 (3d Cir. 1950).

322. *Savage*, *supra* note 315, at 432; see also *Byrer v. Bushong*, 108 F.2d 594 (4th Cir. 1940); *Miners Savs. Bank v. Joyce*, 97 F.2d 973 (3d Cir. 1938); *Tawney v. Clemson*, 81 F.2d 300 (4th Cir. 1936); *In re Orbitronics, Inc.*, 254 F. Supp. 400 (E.D. Wis. 1966); *In re Karolevitz*, 130 F. Supp. 24 (D. Minn. 1955).

323. *Savage*, *supra* note 315, at 432; *Presley*, *supra* note 314, at 1107; see also *Orbitronics, Inc.*, 254 F. Supp. at 404.

324. *Savage*, *supra* note 315, at 432; *Presley*, *supra* note 314, at 1109-10.

325. *In re Torchia*, 188 F. 207 (3d Cir. 1911).

326. *In re Tele-Tone Radio Corp.*, 133 F. Supp. 739, 746 (D.N.J. 1955).

incurred, the secured creditor may have found herself at the mercy of the trustee, who was likely inclined to assess costs liberally in order to maximize the general estate. The courts applying this theory, however, failed to address this concern by providing some sort of guarantee in the form of a standard of reasonableness, necessity, or benefit regarding costs incurred.³²⁷

Under the state foreclosure theory, courts held that the real benefit the secured creditor received from administering her claim in bankruptcy court was the amount she would have expended had she pursued her state court remedy.³²⁸ Several courts specifically adopted this theory as a limit on the amount of costs which could be charged to a secured creditor.³²⁹ As one court asserted in this regard:

The enforcement of . . . [a secured party's] lien in another court would entail upon the proceeds of the property of the bankrupt upon which such lien exists the payment of the appropriate court costs; and so, in the enforcement of such lien in a court of bankruptcy, the proceeds of the property of the bankrupt upon which such lien exists is properly chargeable with the costs of such court appropriate to such enforcement, but with no other or further costs. . . . [The secured creditor is] not chargeable with the general costs of the bankrupt's estate.³³⁰

The rationale for this theory was quite straightforward: because the secured creditor only participated in the bankruptcy proceeding unwillingly, courts found it unfair to charge her with greater expenses than she would have incurred in the forum of her own choice.³³¹ Although some courts applied the theory on its own,³³² most applied it in "conjunction with other theories such as the consent theory or the surplus theory."³³³

As a theoretical matter, limiting a secured creditor's exposure to a hypothetical state court maximum was legitimate when the trustee held the assets for the benefit of the general

327. *Id.*

328. *Savage*, *supra* note 315, at 432; *Presley*, *supra* note 314, at 1109-10.

329. *See, e.g.*, *Textile Banking Co. v. Widener*, 265 F.2d 446, 453 (4th Cir. 1959); *Reconstruction Fin. Corp. v. Rhodes*, 214 F.2d 606, 607 (5th Cir. 1954); *Reconstruction Fin. Corp. v. Cohen*, 179 F.2d 773, 777 (10th Cir. 1950) (Murrah, J., concurring); *L. Maxcy Inc. v. Walker*, 119 F.2d 535 (5th Cir. 1941); *Lerner Stores Corp. v. Electric Maid Bake Shops*, 24 F.2d 780, 781 (5th Cir. 1928); *In re Zehner*, 193 F.2d 787, 791 (E.D. La. 1912); *In re Dawkins*, 34 F.2d 581, 581-82 (E.D.S.C. 1929).

330. *In re William's Estate*, 156 F. 934, 939 (9th Cir. 1907).

331. *See Textile Banking*, 265 F.2d at 454.

332. *Id.*; *see also Gugel v. New Orleans Nat'l Bank*, 239 F. 676 (5th Cir. 1917).

333. *Presley*, *supra* note 314, at 1103; *see, e.g., Rhodes*, 214 F.2d at 607; *L. Maxcy, Inc.*, 119 F.2d at 536 (5th Cir. 1941).

creditors. This theory, however, made little sense when the secured creditor herself elected to foreclose in bankruptcy court. Moreover, it was often difficult to approximate the costs of state court foreclosure proceedings.³³⁴

Also, this theory failed to take into account the default and foreclosure provisions of the Uniform Commercial Code. Under section 9-503, a secured party can take possession of collateral upon default without judicial process if she can accomplish this without a breach of the peace.³³⁵ The provisions of section 9-504, furthermore, allow a secured party to dispose of collateral by public or private proceedings in a commercially reasonable manner and to apply the sale proceeds to the outstanding debt.³³⁶ Most importantly, section 9-504 allows a secured creditor to deduct from the proceeds of the collateral, even before subtracting the amount of the secured indebtedness, the very costs the state foreclosure test assumes she will have to pay out of her own pocket. As a consequence, the secured creditor who was forced to foreclose in bankruptcy might point out that she should not be liable for costs or expenses under these provisions because, outside of bankruptcy, she could have deducted such expenses without impairing her lien. Finally, a secured creditor could avoid entirely the need to sell the collateral, and thereby avoid almost all costs, by utilizing the strict foreclosure remedy of section 9-505.³³⁷ This strict foreclosure provision was particularly attractive to the secured creditor who could make use of the collateral in her business and who feared that a depressed sale of the collateral would bring far less than its actual value.³³⁸

The final theory courts relied on under the Bankruptcy Act was that if the sale of assets free and clear of liens produced a surplus for the general estate by exceeding the secured indebtedness, the general estate would bear the expenses incurred.³³⁹ Courts based this approach on the notion that when a trustee elected to sell assets free of liens to obtain an apparent equity for the general estate, the general estate, not the secured credi-

334. Presley, *supra* note 314, at 1103-04.

335. U.C.C. § 9-503.

336. U.C.C. § 9-504.

337. U.C.C. § 9-505.

338. Presley, *supra* note 314, at 1105-06.

339. *Id.* at 1110-11; *see, e.g.*, Reconstruction Finance Corp. v. Cohen, 179 F.2d 773, 776 (10th Cir. 1950); Rubenstein v. Nourse, 70 F.2d 482, 484 (8th Cir. 1934).

tors, obtained the primary benefit from the proceeding.³⁴⁰ Under a variation of the surplus theory, a number of courts held that when a sale free and clear of liens failed to produce a surplus, the secured creditor could not be compelled to contribute more than the reasonable cost of selling the property to the general estate, usually measured by the actual costs of foreclosure in state court.³⁴¹ Courts reasoned that in such circumstances the trustee abused her discretion in retaining the assets because there was no equity in the property after all: Had the trustee allowed reclamation by the secured creditor, the secured party would have incurred the costs of foreclosure elsewhere.³⁴²

As noted, the most fundamental problem with the surplus theory was that courts frequently disagreed about the types of costs and expenses properly charged to a secured creditor. Although some courts held secured creditors liable for the costs of sale, protection, and preservation of assets, but not the estate's general administrative costs,³⁴³ other courts held that secured creditors should be held liable for neither.³⁴⁴ Additionally, if the court used the existence of a surplus to avoid all costs to the secured creditor, the secured creditor would effectively receive a windfall. This approach unjustly enriched the secured creditor because she avoided all costs of foreclosure, either in state court or otherwise.³⁴⁵

B. COSTS UNDER THE BANKRUPTCY CODE: THE TRADITIONAL SECTION 506 ANALYSIS

In an attempt to codify prior law regarding a secured creditor's liability for costs and expenses related to the preservation or disposition of collateral and to address the above problems that inhered in the theories developed under the Bankruptcy Act, the Congress promulgated section 506(c).³⁴⁶ Section 506(c) provides:

340. Presley, *supra* note 314, at 1111; *see, e.g., In re Street*, 184 F.2d 710 (3d Cir. 1950).

341. *L. Maxcy, Inc. v. Walker*, 119 F.2d 535, 536 (5th Cir. 1941).

342. 4A COLLIER, *supra* note 314, ¶ 70.99[6]; Presley, *supra* note 314, at 1112.

343. *Reconstruction Fin. Corp. v. Cohen*, 179 F.2d at 776.

344. *Rubenstein v. Nourse*, 70 F.2d 482, 484 (8th Cir. 1934); *In re La Rowe*, 91 F. Supp. 52, 56 (D. Minn. 1950).

345. *See Tawney v. Clemson*, 81 F.2d 300, 304 (4th Cir. 1936).

346. 11 U.S.C. § 506(c) (1988). The Fifth Circuit recently noted that § 506(c) is a codification of the "common fund" doctrine. *New Orleans Pub. Serv., Inc. v. First Fed. Sav. & Loan Ass'n (In re Delta Towers, Ltd.)*, 924 F.2d 74, 78-79 (5th Cir. 1991). According to this doctrine, admiralty lien creditors must pay the

The trustee [debtor in possession] may recover from property securing an allowed claim the reasonable and necessary costs and expenses of preserving, or disposing of, such property to the extent of any benefit to the holder of such claim.³⁴⁷

On its face, section 506(c) permits a trustee to recover from a secured party the reasonable costs of preserving or disposing of the secured party's collateral to the extent the secured party benefits from such expenses or costs. This power is significant. Assume, for example, that a creditor has a \$900 allowed secured claim on collateral valued at \$1,000. If the trustee can preserve the collateral's value by a simple repair for \$100, then the trustee does not need to invoke section 506(c) to recover the \$100 repair expense because the expense can be taken directly out of the debtor's equity.³⁴⁸ Suppose, however, that the trustee's expenses equal \$200. In that circumstance, the trustee must invade the secured claim for \$100 of the \$200 expense.³⁴⁹ Importantly, under section 506(c), a trustee cannot invade the secured creditor's claim unless the trustee's section 506(c) claim and the secured creditor's claim against the property are, in combination, greater than the value of the collateral. Only when the two claims overwhelm the collateral's value—when the debtor's equity is exhausted—does section 506(c) sanction the invasion of the secured claim.

The trustee's power to invade a secured creditor's claim under section 506(c) raises three sub-issues: 1) Who may actually recover costs and expenses related to the preservation or disposition of collateral? 2) What are the reasonable costs and

expenses necessary to preserve property in custodia legis. See *New York Dock Co. v. The S.S. Poznan*, 274 U.S. 117, 121 (1927).

347. 11 U.S.C. § 506(c) (1988) (emphasis added).

348. The \$100 expense would be an administrative expense under § 503(b). 11 U.S.C. § 503(b) (1988). The trustee would have an administrative priority for this expense under § 507(a). 11 U.S.C. § 507(a) (1988).

349. Trustees can also invade secured claims by setting off § 506(c) expenses against § 506(b) entitlements to postpetition interest and collection expenses when unencumbered equity still exists. See, e.g., *In re Council*, 1990 WL 266353 (Bankr. E.D. Cal. 1990) (referring to the Supreme Court decision which allowed postpetition interest to the I.R.S. under § 506(b) and stating that "this court believes that since the I.R.S. is entitled to the benefits of sec. 506[b] it is only logical that the I.R.S., in the proper case, should also bear the burdens imposed by 506[b]."); *Crownover v. Manufacturers Hanover Commercial Corp.* (*In re Central Foundry Co.*), 45 B.R. 395, 407-08 (Bankr. N.D. Ala. 1984) (not awarding setoff); *In re Elmwood Farm, Inc.*, 19 B.R. 338, 342 (Bankr. S.D.N.Y. 1982) (allowing trustee to invade secured claims where secured parties were oversecured and entitled to postpetition interest); see also David Carlson, *Secured Creditors and Expenses of Bankruptcy Administration*, 70 N.C. L. REV. 417, 425 (1992).

expenses related to the preservation and disposition of collateral? 3) Under what circumstances will or should a secured party be deemed to benefit from the costs or expenses incurred?

1. Eligibility to Seek Relief Under Section 506(c)

By its terms, section 506(c) specifically provides that only a trustee (or debtor in possession) may recover "the necessary costs and expenses of preserving, or disposing of" secured collateral.³⁵⁰ Applying this language literally, some courts have held that only a trustee or debtor in possession can assess secured creditors for the costs and expenses of preserving or disposing of their property.³⁵¹ In *In re Codesco, Inc.*,³⁵² for example, the debtor's prepetition attorneys attempted to obtain their fees from the sale proceeds of secured collateral by employing section 506(c). The attorneys claimed that their services were required for the preservation and disposition of the estate through liquidation sales of the debtor's assets and that these services benefitted the secured parties.³⁵³ The *Codesco* court found, however, that the attorneys were not the proper parties to make these claims under section 506(c):

Code section 506(c) says: "The trustee may recover. . . . The applicants are neither the trustee nor the debtor-in-possession; they are attorneys retained by the debtor-in-possession. . . . There is nothing in section 506(c) that creates an independent cause of action in favor of the debtor's attorney against the holders of secured claims or their collateral. Implicit in the basis for recovery is that the costs were paid by the estate and that the debtor-in-possession or the trustee, acting for

350. 11 U.S.C. § 506(c) (1988).

351. See, e.g., *Central States Pension Fund v. Robbins (In re Interstate Motor Freight System IMFS, Inc.)*, 17 B.R. 741, 742-45 (Bankr. W.D. Mich. 1987) (denying § 506(c) standing to employee benefit fund); *In re Dakota Lay'd Eggs*, 68 B.R. 975, 976-78 (Bankr. D.N.D. 1987) (holding involuntary gap creditors lacked standing); *In re Groves Farms, Inc.*, 64 B.R. 276, 277 (Bankr. S.D. Ind. 1986) (not allowing equipment lessor to bring § 506(c) claim); *In re J.R. Research, Inc.*, 65 B.R. 747, 749-50 (Bankr. D. Utah 1986) (refusing to allow chapter 11 trustee in case converted to chapter 7 to bring claims); *In re Air Center, Inc.*, 48 B.R. 693, 694 (Bankr. W.D. Okla. 1985) (denying standing to landlord, employees and counsel); *In re Fabian*, 46 B.R. 139, 141 (Bankr. E.D. Pa. 1985) (not allowing landlord); *In re Proto-Specialties, Inc.*, 43 B.R. 81, 83 (Bankr. D. Ariz. 1984) (holding that debtor's landlord lacks standing to seek unpaid rent under § 506(c)); *In re Manchester Hides, Inc.*, 32 B.R. 629, 632-33 (Bankr. N.D. Iowa 1983) (holding attorneys for chapter 7 debtor not proper parties to claim fees under § 506(c)); *In re New England Carpet Co.*, 28 B.R. 766, 771-72 (Bankr. D. Vt. 1983) (stating that attorneys for debtor or committee of unsecured creditors do not qualify as proper parties under § 506(c)); *In re Codesco*, 18 B.R. 225, 230 (Bankr. S.D.N.Y. 1982) (refusing to allow attorneys to recover).

352. 18 B.R. 225 (Bankr. S.D.N.Y. 1982).

353. *Id.* at 226.

the estate, is the proper party to seek a recovery under Code section 506(c).³⁵⁴

In another case, *In re New England Carpet Co.*,³⁵⁵ the court reasoned that because section 506(c) creates an exception to the general rule that administrative expenses are payable from that portion of the debtor's estate not subject to liens, the section should be interpreted restrictively.³⁵⁶ Accordingly, the court held that the right of recovery under this section should be limited to the trustee or debtor in possession and does not extend to attorneys for the debtor or the unsecured creditors' committee.³⁵⁷

Notwithstanding these decisions, a majority of courts have allowed a direct section 506(c) action by a party other than the trustee, recognizing that denying this right to seek costs simply increases overall transaction costs by forcing the party seeking recovery under section 506(c) to arrange for the trustee to bring the identical action on that party's behalf.³⁵⁸ In *Wilson Freight Co. v. Citibank, NA*,³⁵⁹ for instance, the court recognized an implied right to assess attorney's fees and granted counsel for the committee of unsecured creditors interim compensation from the proceeds of secured property. As the court noted:

Congress would not have provided the elaborate procedures envisioned by Chapter 11—including specific authority for the appointment of committees for unsecured creditors and their counsel—unless it intended such provisions to be made workable by permitting the compensation of committee counsel in appropriate situations.³⁶⁰

354. *Id.* at 230.

355. 28 B.R. 766 (Bankr. D. Vt. 1983).

356. *Id.* at 771.

357. *Id.* at 773.

358. See, e.g., *New Orleans Pub. Serv., Inc. v. First Fed. Sav. & Loan Ass'n*, 924 F.2d 74, 76-77 (5th Cir. 1991) (granting standing to utility company under § 506(c) despite seemingly unambiguous language that says trustee may recover under § 506(c)); *Equitable Gas Co. v. Equibank*, (*In re McKeesport Steel Castings Co.*), 799 F.2d 91, 93-94 (3d Cir. 1986) (allowing utility company to assert claim under § 506(c)); *General Elec. Credit Corp. v. Levin & Weintraub* (*In re Flagstaff Food Serv. Corp.*), 739 F.2d 73, 76 (2d Cir. 1984) (allowing attorneys to bring claim under § 506(c)); *In re Evanston Beauty Supply, Inc.*, 136 B.R. 171, 175 (Bankr. N.D. Ill. 1992) (allowing standing for attorney for debtor in possession under § 506(c)); *Wilson Freight Co. v. Citibank, NA*, 21 B.R. 398, 401 (Bankr. S.D.N.Y. 1982) (holding that attorneys for unsecured creditors committee may be allowed interim compensation against secured party's objection even where debtor's estate clearly has no equity); *In re Saybrook Mfg. Co.*, 130 B.R. 1013, 1016 (Bankr. M.D. Ga. 1991); see also Carlson, *supra* note 349, at 430-33 (1992) (stating that not allowing the direct action is "ill-advised.").

359. 21 B.R. 398 (Bankr. S.D.N.Y. 1982).

360. *Id.* at 403.

Similarly, the Second Circuit, in *In re Flagstaff Foodservice Corp.*³⁶¹ recognized an implied right of parties other than the trustee to seek recovery of their costs and expenses. In *Flagstaff*, the debtor's counsel, unsecured creditors' committee counsel and the committee's accountants all made fee requests under section 506(c).³⁶² Although the court did not actually award the requested costs, it recognized their right to make such a request and only denied them costs because they failed to prove that their services benefitted the secured party.³⁶³

This Article endorses the majority view. Requiring a trustee to act as an intermediary for an attorney or other party seeking expenses under section 506(c) accomplishes little. Using a trustee as a go-between simply increases the transaction costs of the bankruptcy as the trustee assumes a role the party seeking its own expenses could have played. Moreover, a trustee will likely lack the same economic incentive to collect the applicable expenses and costs from the secured party as the interested parties themselves. As a result, one might expect that a system which mandates trustee collections would result in windfalls for secured creditors at the expense of other claimants. Finally, secured parties are unlikely to object to allowing claimants to seek their expenses directly from secured parties. They would be hard-pressed to raise a valid objection to such a system as long as they benefit from the relevant expenditure.

2. Reasonable, Necessary Costs of Preserving or Disposing of Collateral

Under section 506(c) a trustee can recover the "reasonable, necessary costs and expenses of preserving, or disposing of," secured collateral.³⁶⁴ Although the Bankruptcy Code does not provide any specific guidance for what types of costs or expenses are reasonable or necessary, numerous decisions have addressed this issue. Courts have generally found costs and expenses such as use, occupancy, security and utility expenses,³⁶⁵ broker's fees,³⁶⁶ auctioneer fees,³⁶⁷ storage charges,³⁶⁸ the costs of pre-

361. 739 F.2d 73 (2d Cir. 1984).

362. *Id.* at 74.

363. *Id.* at 76.

364. 11 U.S.C. § 506(c) (1988).

365. *In re Trim-X, Inc.*, 695 F.2d 296, 1297-1302 (7th Cir. 1982) (vacating and remanding denial of the trustee's reimbursement for use, occupancy, security and utility expenses).

366. *In re E.J. Management Corp.*, 72 B.R. 421, 422-23 (Bankr. M.D. Fla. 1987) (allowing broker's fee for sale of property).

serving or disposing of the subject property,³⁶⁹ and the costs of maintaining, harvesting and marketing crops³⁷⁰ to be reasonable and necessary, unless these costs or expenses do not increase the secured party's recovery or eliminate expenses that the secured creditor would otherwise bear.³⁷¹

Central to the finding that these expenses are reasonable and necessary has been the court's conclusion that these expenses relate directly to the preservation or disposition of collateral and benefit the holder of the secured claim. Courts will not likely find "general administrative costs, overhead, the statutory commissions of the trustee [and] the value of labor of the debtor" to be chargeable against the secured party's collateral absent either: a showing of a resulting benefit to the secured party; or a showing that the secured party consented to the related preservation or disposition.³⁷²

367. *In re Levine's Delicatessen & Restaurant, Inc.*, 53 B.R. 430, 433 (Bankr. S.D.N.Y. 1985) (allowing auctioneer's commissions).

368. *In re Proto-Specialties, Inc.*, 43 B.R. 80, 84 (Bankr. D. Ariz. 1984) (allowing storage charges).

369. *Erickson v. Grubb & Ellis Commercial Brokerage Co. (In re Previs)*, 31 B.R. 208 (Bankr. W.D. Wash. 1983) (mem.) (allowing trustee's reimbursement for costs of preserving property); *In re Neu-Deli Corp.*, 19 B.R. 175, 176 (Bankr. S.D. Ala. 1982) (allowing trustee to charge costs of preservation and disposal against secured claim).

370. *Randall v. Bank of Viola (In re Randall)*, 58 B.R. 289, 291 (Bankr. C.D. Ill. 1986) (allowing a charge for costs of maintaining, harvesting and marketing crops).

371. *See, e.g., Burlington N. R.R. v. Dant & Russell, Inc. (In re Dant & Russell, Inc.)*, 853 F.2d 700, 707 (9th Cir. 1988) (limiting the amount of administrative expense claim based on postpetition rent to portion of leased premises actually used or occupied); *In re Lilly C. Anderson*, 66 B.R. 97, 99 (Bankr. 9th Cir. 1986) (holding that real estate broker was entitled to payment before secured creditors where broker's services saved creditor's expense); *Equitable Gas Co. v. Equibank (In re McKeesport Steel Castings Company)*, 799 F.2d 91, 94-95 (3rd Cir. 1986) (ordering postpetition gas services paid to a utility as administrative expense which benefitted secured creditors); *In re T.P. Long Chem., Inc.*, 45 B.R. 278, 289-90 (Bankr. N.D. Ohio 1985) (refusing to allow EPA expenses in cleanup of hazardous wastes on secured property); *In re West Post Road Properties Corp.*, 44 B.R. 244, 246-7 (Bankr. S.D.N.Y. 1984) (disallowing recovery when secured creditor would have collected full amount of claim and expenses in foreclosure).

372. 3 COLLIER *supra* note 53, ¶ 506.06 at 506-59; *see, e.g., In re Schautz*, 390 F.2d 797, 799 (2nd Cir. 1968) (holding that joint tenant's benefit from sale of secured property entitled trustee to fees notwithstanding amount owed to the joint tenant); *In re Saybrook Mfg. Co.*, 130 B.R. 1013, 1021 (Bankr. M.D. Ga. 1991) (mem.) (holding that trustee generally cannot charge administrative expenses and general costs of reorganization against secured collateral); *In re Baum's Bologna, Inc.*, 50 B.R. 689, 690-91 (Bankr. E.D. Pa. 1985) (holding that debtor's lawyer cannot charge fees because any benefit from services to the creditor was secondary and indirect); *Crownover v. Manufacturers Hanover*

This latter concept regarding consent has its genesis in the line of Bankruptcy Act cases, noted above, which emphasized the consent theory of assessment.³⁷³ In a preeminent case employing this analysis, *In re Hotel Associates, Inc.*,³⁷⁴ the court held that a trustee's investigatory costs and expenses could be charged to secured collateral under section 506(c). The *Hotel Associates* court noted that, in moving for the appointment of a trustee, the secured claimholder impliedly consented to the assessment of such costs against its collateral:

Here, the holder of the secured claim has itself moved for the appointment of a trustee, both to investigate the debtor's affairs and previous dealings, and to facilitate the fund's own Chapter 11 plan. Here, too, the moving party, clearly knew or should have known from the outset that the debtor's estate was insubstantial, apart from the secured's assets.³⁷⁵

3. The Benefit Requirement of Section 506(c)

Under section 506(c)'s final requirement, for the trustee to invade the secured creditor's collateral to cover expenses, the trustee must prove that the expenses, attorneys' fees in this case, produced a "benefit" for the secured creditor. If the trustee cannot demonstrate such a "benefit," courts routinely deny

Commercial Corp. (*In re Central Foundry Co.*), 45 B.R. 395, 406 (Bankr. N.D. Ala. 1984) (holding that trustee is entitled to recover costs and expenses incurred in preserving and selling debtor's inventory and collecting debtor's accounts receivables because creditor benefitted from the liquidation); *Mackin Constr. Co. v. Westfield Sav. Bank (In re Paragon Paper Co.)*, 29 B.R. 963, 964 (Bankr. D.R.I. 1983) (holding that secured creditor must receive some benefit from the activities for which costs were incurred).

373. *In re Hotel Assoc.*, 6 B.R. 108, 111 (Bankr. E.D. Pa. 1980).

374. *Id.* at 111-12

375. *Id.* at 111; see also *In re Pioneer Sample Book Co.*, 374 F.2d 953, 961 (3d Cir. 1967) (observing that the secured creditor "necessarily consented" to disposition and distribution of secured assets by permitting sale and administration in bankruptcy); *Central Foundry*, 45 B.R. at 407 (recognizing creditor as an "impliedly-consenting oversecured creditor"). But see *General Elec. Credit Corp. v. Levin & Weintraub (In re Flagstaff Foodservice Corp.)*, 739 F.2d 73, 77 (2d Cir. 1984) (holding that a secured creditor's employment of Chapter 11 procedure did not impliedly consent to bear general administrative expenses); *Schindler v. Sharak (In re Salzman)*, 83 B.R. 233, 240 (Bankr. S.D.N.Y. 1988) (holding that secured creditor's failure to object to sale free and clear of liens does not imply consent to bear share of administrative expenses); *In re Sherrill*, 78 B.R. 804, 809 (Bankr. W.D. Tex. 1987) (mem.) (holding that the secured creditor's acquiescence to sale cannot imply consent); *In re Perrett*, 63 B.R. 978, 983-84 (Bankr. N.D.N.Y. 1986) (holding that consent to chapter 11 plan does not imply consent to waive secured claim); *Peninsula Fed. Sav. & Loan Ass'n v. Moore (In re Roggio)*, 49 B.R. 450, 453 (Bankr. D. Conn. 1985) (holding that the secured creditor's cooperation in trustee's sale showed consent to sale, not consent to recovery of expenses).

expenses.³⁷⁶

No universally expressed test currently exists for determining when an expense confers a "benefit" for the purposes of section 506(c). Rather, courts have advocated a variety of tests to determine whether to charge expenses, such as attorneys' fees, to a secured creditor. Included among the tests courts have utilized are: a direct/indirect benefit test,³⁷⁷ a purposeful/incidental benefit test,³⁷⁸ a definite/remote benefit test,³⁷⁹ and a "balanc[ing]" test.³⁸⁰ In applying these tests courts have stressed both that the "[b]enefit" to the secured creditor must be shown in . . . [a] quantitative, not . . . qualitative or generalized, sense³⁸¹ and that "[a]ny [mere] tertiary benefit bestowed upon the secured property . . . is too indefinite and remote to

376. See, e.g., *Schindler*, 83 B.R. at 240-41; *In re West Post Rd. Properties Corp.*, 44 B.R. 244, 247-48 (Bankr. S.D.N.Y. 1984); *Federal Land Bank v. Belew*, 44 B.R. 12, 13-14 (Bankr. N.D. Ala. 1984).

377. See, e.g., *New Orleans Pub. Serv. v. First Fed. Savs. & Loan (In re Delta Towers, Ltd.)*, 924 F.2d 74, 77-78 (5th Cir. 1991); *Central Bank v. Cascade Hydraulics & Util. Serv., Inc.*, (*In re Cascade Hydraulics & Util. Serv., Inc.*) 815 F.2d 546, 548 (9th Cir. 1987); *Brookfield Prod. Credit Ass'n v. Borron*, 738 F.2d 951, 953 (8th Cir. 1984); *In re Saybrook Mfg., Co.*, 130 B.R. 1013, 1021 (Bankr. M.D. Ga. 1991); *In re Nat'l Enter. Wire Co.*, 103 B.R. 56, 59-60 (Bankr. N.D.N.Y. 1989); *In re Murray*, 105 B.R. 576, 583-84 (mem.) (Bankr. C.D. Cal. 1989); *In re Kinderhaus Corp.*, 58 B.R. 94, 98 n.4 (Bankr. D. Minn. 1986); *In re Codesco, Inc.*, 18 B.R. 225, 228-29 (Bankr. S.D.N.Y. 1982).

378. See *General Elec. Credit Corp. v. Peltz (In re Flagstaff Foodsource Corp.)*, 762 F.2d 10, 12 (2d Cir. 1985).

379. See *Communication & Studies Int'l, Ltd. v. Bank of Am. (In re World of English)*, 21 B.R. 524, 527 (Bankr. N.D. Ga. 1982); *Codesco*, 18 B.R. at 229.

380. This Article borrows the names for these tests from Professor Carlson's insightful article. See Carlson, *supra* note 349, at 468. The "balancing" test derives from the pre-Code case of *First W. Savs. & Loan Ass'n v. Anderson*, 252 F.2d 544, 548 (9th Cir. 1958), where the court "balance[d] the misfortune of having some allowances go unpaid against the possible inequity of charging them against all mortgaged property." *Id.* The court added that the reviewing court should consider several factors when determining whether a trustee may justifiably make a charge pursuant to § 506(c). First, if things had gone well, would the secured creditor have benefitted? Second, were services rendered primarily for the secured creditor? Third, were the services competently delivered? Fourth, were the secured creditors benefitted by anything which was done in the reorganization proceedings? Fifth, did the secured creditors consent? Sixth, did the secured creditors cause any delays? *Id.* at 548 n.8; see, e.g., *In re Bob Grisset Golf Shoppes, Inc.*, 50 B.R. 598, 603 (Bankr. E.D. Va. 1985), *modified*, 76 B.R. 89 (Bankr. E.D. Va. 1987) (mem.); *In re Manchester Hides, Inc.*, 32 B.R. 629, 634 (Bankr. N.D. Iowa 1983); *In re Korupp Assocs.*, 30 B.R. 659, 662 (Bankr. D. Me. 1983) (mem.); *Communication & Studies Intl.*, 21 B.R. at 527.

381. *Dozoryst v. First Fin. Savs. & Loan Ass'n*, 21 B.R. 392, 394 (N.D. Ill. 1982).

support an allowance" of costs under section 506(c).³⁸² Courts have also held that the party seeking recovery bears the burden of demonstrating the existence and amount of the benefit.³⁸³

In connection with these tests, most courts have held that general administrative expenses may not be charged to a secured creditor because such expenses do not "directly" benefit the secured creditor.³⁸⁴ In one of the leading cases to explore this issue, *In re Codesco*,³⁸⁵ the debtor's reorganization counsel attempted to surcharge the proceeds of the secured claimholder's collateral for administrative fees and expenses related to the sale of the property, and also other general matters of administering the Chapter 11 estate after the debtor converted the proceeding to a Chapter 7 liquidation.³⁸⁶ Denying counsel's request, the court noted that it could find no direct benefit to the secured claimholder from these expenses.³⁸⁷ Rather, in the court's view, all these expenses only benefitted the debtor's general estate during Chapter 11.³⁸⁸ Hence, the attorney could not recover these expenses from the secured party because "section 506(c) was not intended as a substitute for the recovery of administrative expenses that are appropriately the responsibility of the debtor's estate."³⁸⁹

In another celebrated case holding the secured creditor harmless from general administrative expenses, *General Electric Credit Corp. v. Peltz (In re Flagstaff Foodservice Corp.)*,³⁹⁰ the court confronted a failing business that had encumbered vir-

382. *In re Codesco Inc.*, 18 B.R. 225, 229 (Bankr. S.D.N.Y. 1982).

383. For the general proposition that the party seeking recovery has the burden of establishing the existence and amount of the benefit, see *Central Bank v. Cascade Hydraulics & Util. Serv., Inc. (In re Cascade Hydraulics & Util. Serv.), Inc.*, 815 F.2d 546, 548 (9th Cir. 1987); *In re New England Carpet Co.*, 744 F.2d 16 (2d Cir. 1984) (per curiam); *General Elec. Credit Corp. v. Levin & Weintraub (In re Flagstaff Foodservice Corp.)*, 739 F.2d 73, 77 (2d Cir. 1984); *In re Sonoma V.*, 24 B.R. 600, 604 (9th Cir. 1982); *New Orleans Pub. Serv. v. Delta Towers, Ltd. (In re Delta Towers, Ltd.)*, 112 B.R. 811, 815 (Bankr. E.D. La. 1990); *In re Chicago Lutheran Hosp. Ass'n*, 89 B.R. 719, 727 (Bankr. N.D. Ill. 1988); *Federal Land Bank v. Belew (In re Belew)*, 44 B.R. 12, 13-14 (Bankr. N.D. Ala. 1984).

384. See, e.g., *Barr v. Juniata Valley Bank (In re DeLancey)*, 106 B.R. 363, 366-67 (Bankr. S.D.N.Y. 1989); *In re Roamer Linen Supply, Inc.*, 30 B.R. 932, 936 (Bankr. S.D.N.Y. 1983); *In re New England Carpet Company*, 28 B.R. 766, 771-72 (Bankr. D. Vt. 1983) *aff'd* 744 F.2d 16 (2d Cir. 1984) (per curiam).

385. 18 B.R. at 225.

386. *In re Codesco Inc.*, 18 B.R. 225, 226 (Bankr. S.D.N.Y. 1982).

387. *Id.* at 229-30.

388. *Id.* at 229.

389. *Id.* at 230.

390. 762 F.2d 10 (2d Cir. 1985).

tually all of its assets before seeking refuge in Chapter 11.³⁹¹ In *Flagstaff*, the enterprise owed its principal financier, General Electric Credit Corporation (GECC), approximately \$22 million at the time of the bankruptcy petition, secured by \$32-\$42 million in assets.³⁹² To finance the entity during the postpetition period, GECC agreed to loan Flagstaff an additional \$9 million in exchange for a superpriority lien on all of the enterprise's assets pursuant to section 364(d) of the Bankruptcy Code.³⁹³

When it eventually became clear, and that a Chapter 7 liquidation would ensue, Flagstaff only owed GECC approximately \$4 million, but, at that point, GECC found itself undersecured.³⁹⁴ Moreover, all of Flagstaff's remaining assets were encumbered either by GECC's prebankruptcy security interest or its postpetition superpriority lien. To complicate matters further, Flagstaff owed the Internal Revenue Service (IRS) for withholding taxes and its attorneys for services they rendered in connection with the bankruptcy proceeding.³⁹⁵ To recover these costs, the IRS and Flagstaff's attorneys sought to surcharge GECC's remaining collateral under section 506(c).³⁹⁶

The bankruptcy court granted the parties' request that both the attorneys' fees and the withholding tax claim be paid out of GECC's collateral.³⁹⁷ As the court emphasized, the entire Chapter 11 was for GECC's benefit and thus it was only appropriate that GECC pay the administrative costs associated with that proceeding.³⁹⁸ The court added that, by cooperating with the Chapter 11 proceeding, GECC had consented to the accompanying administrative expenses.³⁹⁹

The United States Court of Appeals for the Second Circuit reversed the bankruptcy court.⁴⁰⁰ Addressing the attorneys' fees, the Second Circuit emphasized that, at the start of the Chapter 11 proceeding, GECC was oversecured. As a conse-

391. *Id.* at 11.

392. *Id.* The bankruptcy court noted that the scheduled assets were only \$32 million. *Allstate Fabricators Corp. v. Flagstaff Foodservice Corp.* (*In re Flagstaff Foodservice Corp.*), 56 B.R. 899, 906 (Bankr. S.D.N.Y. 1986).

393. *General Electric Credit Corp.*, 762 F.2d at 11. For a more detailed discussion of this case, see Carlson, *supra* note 349, at 468.

394. *General Electric Credit Corp.*, 762 F.2d at 11.

395. *Allstate Fabricators*, 56 B.R. at 900.

396. *Id.*

397. See *In re Flagstaff Food Service Corp.*, 29 B.R. 215, 220 (Bankr. S.D.N.Y. 1983).

398. *Id.* at 217.

399. *Id.* at 220.

400. *General Electric Credit Corp.*, 739 F.2d at 77.

quence, the court noted that if GECC could have been paid in full at that time through liquidation, it made no sense to conclude that the work of the debtor's attorneys in Chapter 11 benefitted GECC within the meaning of section 506(c).⁴⁰¹ Furthermore, the court rejected the notion that GECC had consented to be charged under section 506(c): "Although a secured creditor may consent to bearing the costs of professional fees incurred by a debtor in possession, 'such consent is not to be lightly inferred.'"⁴⁰²

Notably, in a number of cases in which courts have specifically addressed the narrow issue of whether attorneys' fees can be paid out of the secured party's collateral under section 506(c), courts have denied the attorney's request for fees. In *In re CD Electric Company*,⁴⁰³ for example, the court denied the attorney's request for fees and justified its denial on the ground that most courts which had considered the issue "construed . . . the section 506(c) exception narrowly."⁴⁰⁴ The court noted that it "regret[ed] that . . . [the attorneys], who indisputably performed a substantial amount of work for the debtor in possession, . . . [could] not be compensated for their labors" but that it "was bound to respect the property rights of secured creditors in the collateral securing the debtor's obligations to them."⁴⁰⁵ Likewise, the *In re Michigan Beach Apartments*⁴⁰⁶ court, although recognizing that attorneys' fees might be paid pursuant to section 506(c), noted that "section 506(c) is clearly not for the purpose of providing compensation for debtor's counsel."⁴⁰⁷ Finally, the *In re Sonoma V*⁴⁰⁸ court noted that although attorneys' fees may be paid "at the expense of the secured creditor" under section 506(c), such payments are proper only to the "extent that the secured creditor benefitted from the services."⁴⁰⁹ Because the court found no indication that the secured party benefitted from the attorneys' services, it denied the request for attorneys' fees.⁴¹⁰

Contrary to the trend of these cases, in some recent in-

401. *Id.* at 76-77.

402. *General Elec. Credit Corp.*, 739 F.2d at 77 (quoting *In re S & S Indus.*, 30 B.R. 395, 398 (Bankr. E.D. Mich. 1983)).

403. 146 B.R. 786 (Bankr. N.D. Ind. 1992).

404. *Id.* at 790-91.

405. *Id.* at 791.

406. 61 B.R. 446 (Bankr. N.D. Ill. 1986).

407. *Id.* at 450.

408. 24 B.R. 600 (Bankr. 9th Cir. 1982).

409. *Id.* at 604.

410. *Id.*

stances, courts have compelled secured parties to bear general administrative expenses incurred during the debtor's reorganization. *In re AFCO Enterprises*⁴¹¹ is a leading example of the decisions which have charged secured creditors with a variety of administrative expenses. As the *AFCO* court noted in approving of such charges:

While as a general rule, secured creditors should not be charged with the administrative expenses of administration, the courts have carved out an exception based upon the equitable doctrine of unjust enrichment. When the secured creditor is the only entity which is benefitted by the trustee's work, it should be the one to bear the expense . . . where there is no corresponding benefit to the unsecured creditors.⁴¹²

In reaching this conclusion, however, the court considered and rejected the notion that the secured party should be required to pay the expenses it would have borne had no bankruptcy had taken place.⁴¹³

In another leading case, *In re Johnson*,⁴¹⁴ the debtors sought to use cash collateral for working capital.⁴¹⁵ The court permitted such use, without compensation to the secured creditor, on the theory that the debtor would use the money to maintain the value of cattle which were also collateral for the secured creditor.⁴¹⁶ The court rationalized its decision on the grounds that all the income the business generated belonged to the secured party because the secured party was entitled to proceeds of the cows' milk.⁴¹⁷

Finally, a number of courts have indicated an increasing willingness to permit the imposition of attorneys' fees in the section 506(c) context. In *Uni-Fin Corp. v. McCord Tire & Supply Co.*,⁴¹⁸ for example, the court upheld an award of attorneys' fees under section 506(c) for services the attorneys had performed in negotiating the sale of the assets, arranging interim financing, and negotiating reductions in priority tax claims which would have otherwise impaired the secured creditor's security interest.⁴¹⁹ In awarding fees, the court noted that section 506(c) specifically allows "reimbursement from a creditor for costs and

411. 35 B.R. 512 (Bankr. D. Utah 1983) (mem.).

412. *Id.* at 515.

413. *Id.* at 517-18.

414. 47 B.R. 204 (Bankr. W.D. Wis. 1985).

415. *Id.* at 205-07.

416. *Id.* at 207-09.

417. *Id.* at 207-08.

418. No. 90-C-6764, 1991 WL 18480, at *1-*3 (N.D. Ill. Feb. 7, 1991) (mem.).

419. *Id.* at *3.

attorneys' fees incurred by the debtor or his agent . . . to the extent that such expenses primarily protect or preserve [the] creditor's interest."⁴²⁰ In *Radtke Heat & Sheet Metal v. State Bank of Cherry*,⁴²¹ the court also found that attorneys' fees the debtor incurred to recover accounts receivable on behalf of the estate were properly charged against the creditors who had a security interest in the accounts under section 506(c).⁴²² Likewise, the court in *In re Murray*⁴²³ awarded attorneys' fees where it determined that the attorney's actions "to effectuate a sale of the property free and clear of liens and to initiate litigation on the priority of said liens was a necessary cost . . . [that was] for the benefit of the secured creditor."⁴²⁴ Finally, the *In re Chicago Lutheran Hospital Association*⁴²⁵ court held that although the attorneys could not recover their fees from the secured party's collateral,⁴²⁶ because no evidence suggested that such fees and services "resulted in a higher realizable value for . . . [the secured party's collateral] . . . or that . . . [the attorney's] actions in any way diminished the loss of value to the secured property," the attorneys' fees incurred "in connection with the sale of ancillary properties" of the debtor and the "services rendered in connection with the transition of control of the estate from the debtor in possession to the trustee" could justifiably be recovered pursuant to section 506(c).⁴²⁷

C. A NEW CONCEPTION OF SECTION 506(c)

As discussed earlier, courts have traditionally been reluctant to invade secured collateral to pay for general administrative expenses. Those that have done so universally justify their

420. *Id.* at *2 (emphasis added).

421. 103 B.R. 932 (N.D. Ill. 1989) (mem.).

422. *Id.* at 934-95.

423. 105 B.R. 576 (Bankr. C.D. Cal. 1989) (mem.).

424. *Id.* at 584.

425. 89 B.R. 719 (Bankr. N.D. Ill. 1988).

426. *Id.* at 728.

427. *Id.*; see also *Shaw, Licitra, Parante, Esernio & Schwartz v. Travelers Indem. Co. (In re Grant Assocs.)*, 154 B.R. 836, 842 (S.D.N.Y. 1993) (permitting attorneys to recover fees where such fees where an integral component to maintain the secured collateral); *McAlpine v. Comerica Bank—Detroit (In re Brown Bros.)*, 136 B.R. 470, 473-74 (W.D. Mich. 1991) (observing a necessary and clear benefit accruing to secured creditor from attorney's services); *In re Murray*, 105 B.R. 576, 583-846 (Bankr. C.D. Ca. 1989) (allowing attorney fees connected to both the sale of property free and clear of liens and to the initiation of litigation on priority of liens); *Dahar v. Indian Head Bank N. (In re Mount Cranmore Tennis & Recreation Club, Inc.)*, 42 B.R. 598, 598-99 (Bankr. D.N.H. 1984) (mem.) (permitting a charge against the secured creditor for attorney fees).

action by finding that these expenses afforded a "direct" or "definite" benefit to the secured party. The judicial gloss that courts have placed on section 506(c) requiring this showing of a "direct" benefit to the secured creditor, however, ignores both the language and purposes behind the Bankruptcy Code. Additionally, this test fails to advance the section 506(c) analysis and the determination of whether the secured creditor benefitted from the costs and expenses incurred in connection with the preservation and disposition of its collateral. This judicial focus on "directness" or "primariness" does not really "tell us anything."⁴²⁸ It merely states a legal conclusion, dependent solely on presuppositions, disguised as legal argument.⁴²⁹ This section will illustrate that the judicially-created direct or definite benefit test contravenes the express language of section 506(c). Moreover, this section contends that this interpretation of section 506(c) ignores the policies underlying that section and the Bankruptcy Code in general. Finally, this section maintains that secured creditors are increasingly encumbering all the available assets of debtors leaving little or no remaining equity to finance a bankruptcy and this practice consequently reduces, if not eliminates the opportunity of debtors to seek bankruptcy protection. Relegitimizing the protection bankruptcy affords troubled debtors requires the use of section 506(c) to pay expenses from secured collateral. Consistent with this notion, this section provides a new conceptual framework for interpreting section 506(c).

A review of section 506(c)'s statutory language indicates that its application should not be confined to those situations where the secured party receives a "direct" benefit from the "costs and expenses of preserving, or disposing of," the secured collateral.⁴³⁰ As the applicable language of section 506(c) states, the trustee may recover these costs and expenses "to the extent of *any benefit* to the holder of" the secured claim.⁴³¹ The highlighted language is crucial. The statutory text does not speak in terms of directness; rather, it countenances the notion of "any benefit." The legislative history of this section echoes the same sentiment:

Any time the trustee or debtor in possession expends money to provide for the reasonable and necessary cost and expenses of preserving or disposing of a secured creditor's collateral, the trustee or debtor in

428. Carlson, *supra* note 349, at 468.

429. *Id.*

430. See 11 U.S.C. § 506(c) (1988).

431. *Id.* (emphasis added).

*possession is entitled to recover such expenses from the secured party or from the property securing an allowed secured claim held by such party.*⁴³²

Once again, there is no mention of directness. Instead, the legislative history provides that the recovery of expenses is appropriate "any time" the trustee expends funds to preserve or dispose of the secured collateral.

Thus, both the language and legislative history indicate that secured parties may be assessed the costs and expenses associated with *any* benefit they receive in connection with the preservation or disposition of their secured collateral, including attorneys' fees. Nothing in the text or history of section 506(c) indicates that secured parties should be assessed for expenses only when they receive "direct" benefits therefrom.

Additionally, this "any benefit" reading of section 506(c) furthers the acknowledged purposes behind the enactment of the Bankruptcy Code. The Bankruptcy Code serves two important functions: it provides a collective and allocative forum for sorting out the rights of the various claimants against the debtor's assets, and it provides certain debtors with a financial fresh start.⁴³³ By providing a collective and allocative forum, the Bankruptcy Code seeks to regulate the process by which individual actors make exchanges against a common pool of assets and to maximize the outcome for creditors and equityholders as a whole by maximizing the value of the pool against which each party exchanges its rights.⁴³⁴ Bankruptcy law accomplishes this

432. 124 CONG. REC. H32398 (Sept. 28, 1978) (statement by Rep. Edwards) (emphasis added).

433. Max Radin, *The Nature of Bankruptcy*, 89 U. PA. L. REV. 1, 3-4 (1940).

434. Baird & Jackson, *supra* note 24, at 109-10; Jackson, *Avoiding Powers*, *supra* note 24, at 727-28.

Many disagree with this conception of bankruptcy. Prominent among critics of the economic account is Professor Elizabeth Warren. She argues that bankruptcy law reflects many concerns, both empirical and normative, which cannot be reduced to a single theoretical construct. Elizabeth Warren, *Bankruptcy Policy*, 54 U. CHI. L. REV. 775, 795-97 (1987). In response to the economic account she offers what she admits is "a dirty, complex, elastic, interconnected view of bankruptcy from which [she] can neither predict outcomes nor even necessarily fully articulate all the factors relevant to a policy decision." *Id.* at 811. Under her view, bankruptcy is "an attempt to reckon with a debtor's multiple defaults and to distribute the consequences among a number of different actors." *Id.* at 777. In distributing these "consequences," Warren does not view the maximization of creditor wealth as the predominant concern. Nor does she regard bankruptcy as being about increasing the size of the creditors' pie. Rather, she maintains, bankruptcy, and specifically corporate reorganization, seeks to "acknowledge[] the losses of those who have depended on the business and redistribute[] some of the risk of loss from the

in two ways: through the use of the automatic stay,⁴³⁵ it prevents individual creditor actions aimed at the immediate dismemberment of the common pool;⁴³⁶ and through provisions regulating the distribution of assets,⁴³⁷ it disposes of the pool's assets in a manner that realizes the maximum value of the assets, by a "sale" to either creditors or third parties.⁴³⁸

Significantly, the section 506(c) analysis courts currently employ is not only inconsistent with the specific language of section 506(c), but also fails to comport with these underlying objec-

default." *Id.* at 788. Of particular concern to Warren is that Chapter 11 further "the distributional interests of many who are not technically 'creditors' but who have an interest in a business's continued existence." *Id.* at 787.

Echoing many of the same sentiments as Professor Warren, Professor Korobkin also objects to the economic account and instead offers what he terms a "value-based" account. See Donald R. Korobkin, *Rehabilitating Values: A Jurisprudence of Bankruptcy*, 91 COLUM. L. REV. 717, 721 (1991). In Korobkin's view, bankruptcy law is not intended merely as a response to the problem of collecting debt. Instead, it is an attempt to address the "moral, political, personal, social, and economic" aspects of financial distress and the effects such financial distress has on the many parties it affects. *Id.* Korobkin argues that the fundamental thrust of bankruptcy law is to provide "a forum for an ongoing debate in which [the] diverse values [of the participants] can be expressed and sometimes recognized." *Id.* For him, bankruptcy "[l]oosely speaking[,] . . . accomplishes a kind of 'group therapy.'" *Id.* at 722. "The value-based account thus explains bankruptcy law as a system with varied contours and dimensions, having the distinct function of facilitating and expression and recognition of those diverse values important in dealing with financial distress." *Id.*

435. See 11 U.S.C. § 362 (1988).

436. See JACKSON, LOGIC AND LIMITS, *supra* note 24, at 14-15, 151-52.

437. See, e.g., 11 U.S.C. § 1129 (1988).

438. See JACKSON, LOGIC AND LIMITS, *supra* note 24, at 210-13; Baird & Jackson, *supra* note 24, at 108 n.40. According to the law and economics school, a reorganization should be viewed merely as "a form of asset sale." See JACKSON, LOGIC AND LIMITS, *supra* note 24, at 210-13; Douglas G. Baird, *The Uneasy Case for Corporate Reorganizations*, 15 J. LEGAL STUD. 127, 127 n.1 (1986). As these scholars maintain, in a Chapter 11 reorganization, the entity's assets are essentially sold to existing participants. That is, a "forced sale" occurs wherein investors sell their claims and receive in return a share of the reorganized company. In a Chapter 7 liquidation proceeding, by contrast, a firm relinquishes all of its assets to the control of a trustee who sells the assets — either piecemeal or as a functioning unit — to third parties and distributes the proceeds to the firm's residual claimants. See JACKSON, LOGIC AND LIMITS, *supra* note 24, at 210-12 (arguing that both reorganization and liquidation are sales of an entity's assets: reorganization involves a sale to existing claimants and liquidation a sale to third parties); Baird, *supra*, at 127 n.1 (1986) (stating that a reorganization is a "forced sale" whereby an "investor 'sells' his claim and receives in return a share of the reorganized company"); see generally Thomas H. Jackson, *Bankruptcy, Non-Bankruptcy Entitlements, and the Creditor's Bargain*, 91 YALE L.J. 857, 893-96 (1982) (discussing theory of Bankruptcy Code Chapter 7 liquidation and Chapter 11 reorganization, and describing reorganization as a form of liquidation).

tives. Courts using the direct benefit test to interpret section 506(c) have focused strictly on whether the secured party benefits directly from the relevant expenses, they have not considered whether the expenses at issue maximized the overall value of the pool of assets available for distribution and thereby indirectly benefitted the secured party. Nor have courts considered the fact that all creditors, including secured creditors, may benefit from the use of bankruptcy as the forum for loss allocation and asset distribution. By providing a centralized forum to serve these functions, bankruptcy reduces the overall transaction costs associated with asset distribution and thereby increases the overall size of the estate available to interested parties.⁴³⁹ Secured creditors, moreover, seemingly recognize this fact. In numerous cases, secured creditors consent to funding the debtor's legal fees from their own collateral, undoubtedly in recognition that their interests are better served by having the debtor represented by counsel in a bankruptcy proceeding.⁴⁴⁰

The "direct" benefit interpretation of section 506(c) also contravenes the Bankruptcy Code's larger "fresh start" policy. The fresh start policy encourages entrepreneurialism by not terminally punishing those who fail, provides a safety net of sorts for those incapable of judging their own fallibility, and lessens individual self-hatred. Because creditors have increasingly sought to encumber all of a debtor's assets, however, there is often little equity available to pay attorneys' fees in connection with a debtor's bankruptcy.⁴⁴¹ Payment of these fees, of course, is critical if the debtor is to have an opportunity to engage in a "fresh start." Few attorneys, after all, work for free.

Under their current interpretation of section 506(c), courts require the trustee to demonstrate a direct benefit to the se-

439. For an excellent overview of collection remedies under state law and the advantages bankruptcy's collective scheme offers over individual collection remedies, see Susan Block-Lieb, *Fishing in Muddy Waters: Clarifying the Common Pool Analogy as Applied to the Standard for Commencement of a Bankruptcy Case*, 42 AM. U. L. REV. 337, 351-58, 386-396 (1993).

440. See, e.g., *In re Annett Ford, Inc.*, 62 B.R. 65, 69 (Bankr. D. Neb. 1985) (finding preservation of business's going concern value can benefit secured creditor and warrant debtor's attorney's fees), *rev'd in part*, 64 B.R. 946 (D. Neb. 1986); *In re Modica*, 55 B.R. 605, 607 (Bankr. W.D. Va. 1985) (finding secured creditor consent to debtor's attorney's fees).

441. See, e.g., *First Western Sav. & Loan v. Anderson*, 252 F.2d 544 (9th Cir. 1958); *In re Fazio*, 57 B.R. 316 (Bankr. E.D. Pa. 1986); *In re Bob Grissett Golf Shoppes, Inc.*, 50 B.R. 598 (Bankr. E.D. Va. 1985); *In re Proto-Specialists, Inc.*, 43 B.R. 81 (Bankr. D. Ariz. 1984); *In re Hotel Assocs.*, 6 B.R. 108 (Bankr. E.D. Pa. 1980).

cured party before she may pay fees and expenses from secured collateral. Accordingly, a debtor whose collateral is completely encumbered, can only get money to fund her fresh start by showing that such payments also directly benefit the secured party. In essence, then, the current interpretation of section 506(c) forecloses bankruptcy as an avenue of relief for debtors who lack sufficient unencumbered collateral to pay attorneys' fees unless the secured party consents to the use of her collateral for such fees. Thus, bankruptcy, often the most desirable option for a debtor in financial distress, is removed from the list of possible avenues of relief for a troubled debtor. Even more alarming, it is the creditor, often the debtor's most influential creditor, who removes this avenue, creating, one would expect, numerous opportunities for abuse.

To relegitimate and preserve bankruptcy as a forum open to debtors in financial distress, this Article posits a framework for section 506(c) that balances the direct and indirect benefits realized by the secured creditor and the estate in connection with the preservation or disposition of secured collateral against the costs and expenses associated with that preservation or disposition. Under this test, the directness or remoteness of the benefits the secured party derives is irrelevant. Rather, all the benefits accruing to the secured party and the estate as a result of the attorney's services would be considered in assessing costs and expenses.

The balancing test this Article advocates operates in the following fashion. On one side of the equation are the inherent benefits that both the secured party and the debtor (the estate) derive from bankruptcy. These parties derive numerous benefits. For the secured party, bankruptcy provides an opportunity to engage in an organized, well-developed collection proceeding orchestrated by a judge and attorneys familiar with the proper procedures and well-attuned to maximizing creditor wealth. As many scholars have recognized in this regard, bankruptcy exists and endures precisely because it is the most efficient system for protecting and allocating creditor wealth.⁴⁴² Moreover, the trustee and the debtor in possession have a duty in bankruptcy

442. See, e.g., Frank H. Easterbrook, *Is Corporate Bankruptcy Efficient?*, 27 J. FIN. ECON. 411, 413 (1990). Judge Easterbrook argues that bankruptcy has survived as an "[e]nduring legal institution." *Id.* (noting that such institutions "endure either because they are efficient or because they redistribute wealth to concentrated, politically effective interest groups."). Finding no redistributive effect, Easterbrook asserts that efficiency is the only likely explanation for bankruptcy's survival. *Id.* at 413-14.

to maximize creditor wealth.⁴⁴³ From the debtor's perspective, bankruptcy offers the obvious advantage of a fresh start.⁴⁴⁴ Balanced against these benefits, on the other side of the equation, are the costs associated with the attorney's services. As should be apparent, although these costs may be high in a given circumstance,⁴⁴⁵ they will generally be significantly less than the myriad of benefits derived by the secured creditor *and* the estate from the bankruptcy.

A critic of the test this Article proposes might contend that it proves too much, that under this formulation a secured party would always be required to pay the costs of the bankruptcy proceeding. To mitigate against this possibility, this Article advocates a structure wherein the secured creditor would only have to pay the expenses associated with bankruptcy when there is no equity left to pay for such costs. Equity would be used first to fund the bankruptcy and only when it has been exhausted would the secured party be responsible for funding any additional costs. Thus, this Article's interpretation of section 506(c) requires the secured party to pay expenses only when no other alternative means of funding the bankruptcy exists.⁴⁴⁶

Notably, there are alternative means for debtors with little equity to finance bankruptcy proceedings apart from the use of section 506(c) this Article proposes. Courts could aggressively use avoidance powers to release encumbered collateral. Congress could enact legislation that requires interested parties to pay attorneys' fees, as is done in civil rights actions under 42 U.S.C. 1982.⁴⁴⁷ Finally, the bankruptcy estate, creditors, or

443. See *Pepper v. Litton*, 308 U.S. 295, 310-11 (1939); *Federal Deposit Ins. Corp. v. Sea Pines Co.*, 692 F.2d 973, 976-77 (4th Cir. 1982); *Automatic Canteen Co. of Am. v. Wharton*, 358 F.2d 587, 590 (2d Cir. 1966); *Davis v. Woolf*, 147 F.2d 629, 633 (4th Cir. 1945); *In re Baldwin-United Corp.*, 43 B.R. 443, 459 n.22 (S.D. Ohio 1984); *Lilly v. Ernst*, 113 F. Supp. 178, 181 (S.D.W. Va. 1952); *In re Western World Funding, Inc.*, 52 B.R. 743, 763 (Bankr. D. Nev. 1985); see also William W. Bratton, Jr., *The Economics and Jurisprudence of Convertible Bonds*, 1984 WIS. L. REV. 667, 734 n.247; Stephen H. Case, *Fiduciary Duties of Corporate Directors and Officers, Resolution of Conflicts Between Creditors and Shareholders, and Removal of Directors by Dissident Shareholders in Chapter 11 Cases*, in WILLIAMSBURG CONF. ON BANKRUPTCY 373, 391-93 (ALI-ABA Invitational Conference Study Materials).

444. See *supra* note 434 and accompanying text.

445. See *supra* notes 2-3.

446. Admittedly, and problematically, this may often be the case.

447. See 42 U.S.C.A. § 1988(b),(c) (Supp. III 1991) (allowing recovery of attorney fees in actions brought under 42 U.S.C. §§ 1981, 1981a, 1982, 1983, 1985, 1986); see also 15 U.S.C. § 1640(a)(3) (1988) (allowing recovery of attorney fees in patent cases).

some combination thereof could be taxed to pay for the costs of the bankruptcy proceeding.

Each of these alternatives is problematic, however. An expansive use of the trustee's avoidance powers in this fashion would contravene the intended purposes of such powers.⁴⁴⁸ New legislation providing for the payment of attorneys fees in bankruptcy akin to other attorney fee provisions would have to be enacted. Finally, using taxation to pay such costs would likely increase the overall costs of the bankruptcy because of the heightened transaction costs accompanying government involvement. In contrast, the use of section 506(c) to fund bankruptcies could be accomplished without any of these problematic changes. All that is required is a new interpretation of section 506(c).

D. GAME THEORY AND THE RECOVERY OF ATTORNEYS' FEES UNDER SECTION 506(C)

Application of game theory in the context of paying attorneys' fees out of the proceeds of secured collateral illustrates that the interpretation of section 506 proposed by this Article best promotes the interests of both creditors and debtors by maximizing the value of the common pool. In sum, regardless of the funding alternative chosen, game theory supports the proposition that the collective and allocative scheme bankruptcy offers vis-a-vis individual state collective remedies is in the interest of all the relevant players.

In the last two and one-half decades, game theory has increasingly come to dominate microeconomic theory,⁴⁴⁹ becoming what one economist has described as the "premier fashionable tool of microtheorists."⁴⁵⁰ More recently, theorists have frequently employed game theory to analyze legal problems and offer possible solutions.⁴⁵¹

448. See *supra* notes 439-440 and accompanying text.

449. The prominence of game theory is, at least in part, a product of one highly influential work: ANOTOL RAPOPORT & ALBERT M. CHAMMAH, *PRISONER'S DILEMMA: A STUDY IN CONFLICT AND COOPERATION* (1965).

450. Franklin M. Fisher, *Games Economists Play: A Noncooperative View*, 20 RAND J. ECON. 113, 113 (1989); see also Carl Shapiro, *The Theory of Business Strategy*, 20 RAND J. ECON. 125, 125 (1989) ("This new wave of [industrial organization] research consists almost exclusively of game-theoretic studies of behavior and performance in imperfectly competitive markets.").

451. See, e.g., David Carlson, *Game Theory and Bankruptcy Reorganizations*, 9 BANKR. DEV. J. 219 (1992); Douglas G. Baird & Randal C. Picker, *A Simple Noncooperative Bargaining Model of Corporate Reorganizations*, 20 J. LEGAL STUD. 311 (1991); Martin Shubik, *Game Theory, Law, and the Concept of*

Game theoretic modelling consists of defining the rules of a game and then "solving" the game, by deriving the best strategies for each player and the equilibrium that will result if each player undertakes her best strategy. To establish the "rules of the game," one must define: 1) the players—the individuals who make decisions; 2) the order of play and actions available to each player at each point during the game; 3) the information available to the relevant parties when they make their decisions; and 4) the outcomes that result from the players' actions.⁴⁵² To solve the game, one must decide what constitutes an equilibrium of "best strateg[ies],"⁴⁵³ and choose an equilibrium or solution concept.⁴⁵⁴ The most commonly used solution concept is one of dominant strategy equilibrium.

Under the dominant strategy equilibrium, assume, mathematically, that the notation S_i represents the combination of strategies of every player except i . Player i is intensely interested in this combination because she uses it to help choose her own strategy. The following notation defines i 's best response, S_i^* :

$$\pi_i(S_i^*, S_{-i}) \geq \pi_i(S'_i, S_{-i}) \quad \forall S'_i \neq S_i^*.$$

The strategy S_i^* represents a dominant strategy if it comprises a player's absolutely best response to any strategies the other players might choose. Thus, whatever strategies the other players choose, player i 's payoff is highest with S_i^* . Mathematically:

$$\pi_i(S_i^*, S_{-i}) > \pi_i(S'_i, S_{-i}) \quad \forall S_{-i}, \quad \forall S'_i \neq S_i^*.$$

A player's dominant strategy is her strictly best response even to ignorant actions by other players. Significantly, most games do not have dominant strategies, and the players must try to ascertain each others' actions to choose their own.

Game theory, like the common pool problem noted above, illustrates situations in which the self-interested actions of individuals fail to achieve a socially optimal result. One such example is the prisoner's dilemma, which has a dominant strategy

Competition, 60 U. CIN. L. REV. 285 (1991); Jeffrey N. Gordon, *Shareholder Initiative: A Social Choice and Game Theoretic Approach to Corporate Law*, 60 U. CIN. L. REV. 347 (1991).

452. ERIC RASMUSEN, *GAMES AND INFORMATION: AN INTRODUCTION TO GAME THEORY* 22-25 (1988). All the mathematic modelling in this section is derived from Rasmussen's highly practical text.

453. *Id.* at 27.

454. *Id.*

equilibrium. Assume, for example, that two coconspirators are taken prisoner for committing a crime. Before being taken prisoner, the two individuals have each sworn to remain loyal to each other by keeping quiet. The prisoners know that if one prisoner confesses, the authorities will strike a deal with that prisoner and convict the other. Assume further that if one prisoner confesses and the other does not, the confessing prisoner will be set free while the noncooperative prisoner will spend five years in jail. If they both confess, both will be held for three years. Suppose, finally, that if neither confesses they will both serve one year in jail. The matrix in Table 1 below illustrates the game's possible results. Entries in each cell represent the "utility" that each prisoner assigns to the various possible results.⁴⁵⁵

TABLE 1

		PRISONER 1	
		Keeps Quiet	Confesses
PRISONER 2	Keeps Quiet	-1 (KQ), -1 (KQ)	-5 (SP), 0 (TC)
	Confesses	0 (TC), -5 (SP)	-3 (C), -3 (C)

To understand the prisoner's dilemma, place yourself in the position of Prisoner One (*P1*). If Prisoner Two (*P2*) denies involvement (choosing to keep quiet), *P1* will be better off confessing because she can avoid a prison sentence. If *P2* confesses, *P1* is still better off confessing because her prison term will only extend three years instead of five. Thus, regardless of *P2*'s action, *P1* is better off confessing. In either case, *P1* does better by confessing, and because the game is symmetric, *P2* has the same incentives.

In this game, the confessing strategy is dominant because, no matter what the other player does, each player possesses only one optimal strategy. Thus, a fundamental characteristic of the

455. "Utility" can be thought of as a measure of value that a prisoner receives from deciding whether to confess or keep quiet. In this model, utility is measured as the negative of the length of each prisoner's resulting jail term. In addition, each entry has been assigned a corresponding label: "KQ" represents the value each prisoner receives when both prisoners keep quiet; "TC" represents the "temptation to confess"—the benefit a prisoner receives when she confesses and the other prisoner keeps quiet; "SP" represents the "sucker's payoff"—what a prisoner receives when she keeps quiet and the other prisoner confesses; and "C" represents the value each prisoner receives when both prisoners confess.

prisoner's dilemma is the presence of an act whose benefits exceed its costs for a single individual but whose aggregate costs to all affected parties exceed its benefits. In other words, "[t]he central feature of a prisoner's dilemma is rational individual behavior that, in the absence of cooperation with other individuals, leads to a sub-optimal decision when viewed collectively."⁴⁵⁶ Importantly, this situation is pareto inefficient because both prisoners would be better off if neither confessed.⁴⁵⁷ In short then, a matrix reflects a prisoner's dilemma where the temptation to confess (TC), exceeds the reward for mutually keeping quiet (KQ), which is worth more than punishment for mutual confessing (C), which is worth more than the sucker's payoff (SP) (the payoff for the party who kept quiet while the other confessed).⁴⁵⁸ Mathematically stated, a prisoner's dilemma exists because $TC > KQ > C > SP$, or $0 > -1 > -3 > -5$. Actually, the result is even stronger than that. Because the equilibrium is a dominant strategy equilibrium, the information available to each prisoner when she makes her decision about the other's likely behavior does not matter. Even if $P1$ knows $P2$'s move before making her own, the equilibrium remains unchanged. $P1$ would still choose to confess, because she knows $P2$ will surely choose confession afterwards.

Professor Jackson described the decision between individual and collective collection remedies as analogous to the prisoners' dilemma because "[e]ach creditor, unless assured of the other's cooperation, has an incentive to take advantage of individual collection remedies, and to do so before the other creditor acts."⁴⁵⁹ Table 2 depicts a matrix representing the hypothetical results of this unsecured creditors' dilemma. The entries in each cell represent the utility that Creditor One ($C1$) and Creditor Two ($C2$) would assign to the various possible results.⁴⁶⁰

456. Jackson, *Non-Bankruptcy Entitlements*, *supra* note 438, at 862; see Block-Lieb, *supra* note 439, at 320-71 n.142.

457. HAL R. VARIAN, *INTERMEDIATE MICROECONOMICS: A MODERN APPROACH* 15-16 (2d ed. 1990). Pareto optimality (efficiency) exists when the allocation of resources is such that no change in allocation can be made without reducing the satisfaction of at least one party. *Id.*

458. See ROBERT AXELROD, *THE EVOLUTION OF COOPERATION* 9-10 (1984).

459. Jackson, *Non-Bankruptcy Entitlements*, *supra* note 438, at 862.

460. This particular model, as well as the prisoner's dilemma discussion, is borrowed in part from Block-Lieb's excellent article, *supra* note 439, at 370-71, n.142. In this model, utility is measured as the negative of the amount each creditor would receive in collecting claims against the debtor. "A" represents the value of the bankruptcy estate—the value of cooperation for both creditors. When both creditors pursue a collective remedy this value is divided between them, recognizing that they will share "A" in a pro-rata proportion. "B" repre-

TABLE 2

		CREDITOR 1	
		Collective	Individual
CREDITOR 2	Collective	A/2 (C), A/2 (C)	0 (SP), B (TI)
	Individual	B (TI), 0 (SP)	B/x (I), B/x (I)

As should be apparent, similar to the prisoner's dilemma above, if *C1* pursues individual remedies against a debtor that owes both *C1* and *C2*, *C2* will prefer to do the same. If *C1* instead chooses collective action, however, *C2* will still prefer to pursue her individual remedies because this will maximize her ability to recover the debt, as opposed to sharing pro rata with *C1* and receiving a lesser amount. In short, "[u]nless each creditor individually attempts to 'beat out' the other, that creditor will fare worse than the other."⁴⁶¹ Again, like the prisoners' dilemma, however, both creditors are better off if they cooperate with one another and commence a voluntary proceeding. Similar to the prisoners' dilemma, these creditors face a dilemma where the temptation to take individual action (*TI*) is greater than the benefit received if both take collective action (*C*), which is greater than the benefit received if both take individual action (*I*), which is finally greater than the benefit received if only one takes collective action (*SP*). Thus, we can express the situation as $TI > C > I > SP$, or, stated in terms of Table 2, $B > A/2 > B/x > 0$.

Now, posit a situation where the two players are a secured party (*SP*) and a debtor (*D*). Assume further that if an event of default is imminent or has already occurred, *SP* or *D* may only choose between two courses of action: individual Article 9 self-help remedies or a collective bankruptcy proceeding. In this sit-

sents the value each creditor would receive pursuant to individual state remedies. Note that the "*B/x*" values are not certain, but rather represent the probability of recovery each creditor faces before she pursues her individual remedy. In this situation, once the creditors have completed their race to the courthouse, either *C1* or *C2* will be paid in full depending on what priority rule the relevant state follows, while the other creditor receives nothing.

Each entry has also been assigned a corresponding label: "*C*" represents the value each creditor receives when both creditors take collective action; "*TI*" represents "temptation to take individual action the other creditor does not; "*SP*" represents the "sucker's payoff"—what a creditor receives (nothing) when she pursues collective action but the other creditor takes individual action; and "*I*" represents the value each creditor receives when both creditors take individual action.

461. Jackson, *Non-Bankruptcy Entitlements*, *supra* note 438, at 862.

uation, *SP* can choose which action to pursue to recover her collateral while *D* can choose between initiating a voluntary bankruptcy (action) or allowing *SP* to seize the collateral or force *D* into bankruptcy (inaction). Neither event is ideal because both involve costs. Nonetheless, the optimum event will produce the minimum costs for either party.

Further, imagine that both parties know the expected costs and benefits of choosing one venue over another but that neither knows which proceeding the other will choose. Now, assume that either party can choose the venue in which to proceed initially. *SP* can either choose to seize *D*'s property⁴⁶² or, depending on her situation, to force *D* into an involuntary bankruptcy.⁴⁶³ If *SP* chooses to seize the collateral and *D* decides to file bankruptcy or challenge the seizure, *SP* will incur expenses both in pursuing the seizure and in the bankruptcy. These expenses can be denoted as (-4). If *SP* chooses bankruptcy, however, she only bears the expenses of proceeding in bankruptcy, regardless of *D*'s choice. These expenses can be denoted as (-2). Moreover, because of the efficiencies of the bankruptcy system of solving the common pool problem, *SP*'s costs can be expected to be lower in bankruptcy irrespective of any individual collection costs than in the realm of state collective remedies.⁴⁶⁴

462. If the debtor is in default, U.C.C. § 9-503 allows a secured creditor to seize the debtor's property, and § 9-504 allows the secured creditor to sell, lease, or otherwise dispose of the seized collateral. Alternatively, if the debtor is merely in financial distress, most security agreements contain an insecurity clause which permits the secured party to declare the debt due and foreclose on the debtor's secured assets. *See, e.g.,* *Continental Bank v. Modansky*, 997 F.2d 309, 313-14 (7th Cir. 1993); *Useden v. Acker*, 947 F.2d 1563, 1567 n.2 (11th Cir. 1991); *Wateska First Nat'l Bank v. Ruda*, 552 N.E.2d 775, 778 (Ill. 1990); *In re Farmer*, 13 B.R. 319, 320 (Bankr. M.D. Fla. 1981).

463. Under Bankruptcy Code § 303, creditors can file an involuntary petition for a Chapter 7 liquidation, 11 U.S.C. §§ 701-66 (1988), or a Chapter 11 reorganization, 11 U.S.C. §§ 1101-74 (1988), against an eligible debtor, *see* 11 U.S.C. §§ 109(a),(b),(d) (1988) (articulating general debtor eligibility requirements under Chapters 7 and 11 of the Bankruptcy Code). Generally three or more creditors holding claims that are at least \$5000 more than the value of any lien of the debtor's property which they hold can bring an involuntary action. 11 U.S.C. § 303(b)(1). If the debtor has fewer than 12 creditors, however, a single creditor that holds claims of at least \$500 may bring such an action. 11 U.S.C. § 303(b)(2). While the relevant creditors must hold unsecured claims exceeding \$5,000, § 303 does not preclude a fully secured creditor from joining in an involuntary petition. *See Paradise Hotel Corp. v. Bank of Nova Scotia*, 842 F.2d 47, 49 (3d Cir. 1988) (holding that fully secured creditor could join involuntary petition with two creditors whose unsecured claims exceed \$5,000).

464. *See supra* notes and accompanying text. Of course, to a great extent, the *SP*'s costs are reduced in bankruptcy only if other creditors hold competing

D has the same two alternatives and can choose between inaction, allowing the seizure and foregoing bankruptcy's advantages, or filing bankruptcy and thereby taking advantage of the protection afforded by bankruptcy. If *D* chooses bankruptcy she will bear costs of (-2), but if she chooses inaction she will incur costs of (-4). *D* can be expected to bear lower costs in bankruptcy because of the advantages that bankruptcy offers her, from a chance for a fresh start to the opportunity to rehabilitate a failed entity. Moreover, *D* can be expected to bear lower costs in bankruptcy because individual creditor races to the courthouse "not only create[] costs for the individual creditor (such as frequent checking of courthouse records for evidence of actions against the debtor by other creditors), . . . [but] also [are] likely to lead to a premature termination of a debtor's business."⁴⁶⁵ Table 3 denotes the situation that both parties face in matrix form:

TABLE 3

		DEBTOR	
		Self-Help Seizure (Inaction)	Bankruptcy (Action)
SECURED PARTY	Self-Help Seizure	-3 (SHS), -4 (SHS)	-4 (SHS), -2 (B)
	Bankruptcy	-2 (B), -4 (SHS)	-2 (B), -2(B)

Table 3 makes evident that the equilibrium for either party arises when both parties independently choose bankruptcy. The parties prefer bankruptcy, with a cost of (-2) to the self-help seizure with a cost of (-4). So, both parties prefer $B > SHS$. Unlike the prisoners' dilemma, the parties' dominant equilibrium also represents the pareto efficient equilibrium. Both parties benefit by cooperating. Both parties benefit by choosing the collective forum of bankruptcy, rather than pursuing, or waiting for the other party to pursue, individual collection remedies. As such, bankruptcy presents the optimum solution for resolving situations of financial distress. This Article's formulation affirmatively employs section 506(c) to sanction and promote recourse to this optimal solution.

claims to *D*'s assets. If *SP* has privatized the common pool problem, by being *D*'s only creditor, *SP*'s costs may well be lower in pursuing state collective remedies. This, however, does not suggest that bankruptcy should not still be the preferred social alternative—particularly where bankruptcy may protect certain stakeholders of *D*.

465. Jackson, *Non-Bankruptcy Entitlements*, *supra* note 438, at 862.

CONCLUSION

A contemporary rash of bankruptcy filings by large corporate debtors has focused attention on the often staggering attorneys' fees these lengthy and complex proceedings necessitate. Anticipating these fees, corporate debtors, contemplating bankruptcy but possessing few unencumbered assets, often dispose of secured collateral and apply the proceeds toward prepetition attorneys' fees and retainers for postpetition services. Under Article 9, however, a secured party generally retains a security interest in the proceeds of its secured collateral. This general rule raises a fundamental issue: Whether a secured party may recover its interest in proceeds used to pay the debtor's attorneys' fees.

Allowing the secured party to protect its interest coheres with Article 9's general principles, but undermines the values inherent in the Bankruptcy Code by limiting the debtor's ability to procure legal representation and hence, the debtor's access to the bankruptcy system. Although a secured party can potentially recover its interest in proceeds by various means, this Article posits that paying attorneys' fees in bankruptcy from the proceeds of secured collateral is consistent with the Code's language and purposes and maximizes overall economic efficiency.

A secured party can mount two distinct challenges to the payment of attorneys' fees through proceeds: a direct challenge and an indirect challenge. In the former, the secured party claims that the debtor's attorney has converted the secured party's collateral by refusing to disgorge fees paid with the proceeds of that collateral. The attorney can defeat the secured party's conversion claim, however, either by demonstrating that the secured party authorized the debtor's disposition of the collateral and its proceeds or by establishing that she has priority over the secured party.

The secured party may indirectly challenge the payment of attorneys' fees from proceeds by establishing that the payment constitutes either a voidable preference under section 547 of the Code or a fraudulent conveyance under section 548 of the Code. A preference is any transfer of the debtor's property on the eve of or in contemplation of bankruptcy which satisfies an antecedent debt. Virtually all transfers made within the 90 day preference period as compensation for the attorney's prepetition services will constitute a preference under section 547(b). Unless the attorney can establish that the payment satisfies a section 547(c) exception, the payment is voidable and recoverable by the

trustee under section 550(a). In this context, the attorney will likely invoke either the contemporaneous new value exception of section 547(c)(1) or the ordinary course of business exception of section 547(c)(2).

The secured party can also indirectly challenge the debtor's payment of proceeds to her attorney by asserting that the payment constitutes a fraudulent conveyance under section 548 of the Code. Under section 548(a), the trustee can avoid any fraudulent transfer, both actual and fraudulent, of the debtor's property made within one year prior to the debtor's bankruptcy petition. Under this definition, a general retainer paid by an insolvent debtor within one year of a future bankruptcy proceeding is a constructively fraudulent conveyance unless the debtor received "reasonably equivalent value" from the attorney's executory promise of future services. If the transfer to the attorney is voidable under section 548(a), the attorney may be able to rely on section 548(c) to limit the trustee's recovery. Section 548(c) provides a pro tanto defense and allows a good faith transferee to avoid the trustee's recovery to the extent the transferee provided value.

Despite the potential challenges to the payment of attorneys' fees a secured party can offer, paying attorneys' fees in bankruptcy from the proceeds of secured collateral is consistent with the language and purposes of the Bankruptcy Code. To facilitate this practice, this Article offers a new interpretation of section 506 of the Code that would allow a trustee to recover from a secured party's interest in collateral the reasonable costs of preserving that collateral, including attorneys' fees. This interpretation properly recognizes the overall benefits a bankruptcy proceeding affords relative to other creditors' remedies.

Section 506(c) of the Code allows the trustee, after the debtor's equity has been exhausted, to invade secured collateral to pay the necessary costs of preserving or disposing of the collateral "to the extent of any benefit to the holder of such claim." Courts have held that the trustee may only recover those costs that confer a direct or immediate benefit to the secured party. To preserve bankruptcy as a forum for debtors, this Article proposes that section 506(c) be interpreted in a manner which balances the direct and indirect benefits attained by the secured party and the estate by the preservation and disposition of secured collateral against the costs and expenses thereof. This interpretation would properly take into account the inherent benefits of collective distribution that both the secured party

and the debtor receive from bankruptcy. Against these benefits are balanced the costs of the attorney's services. Although these costs are often substantial, this Article posits that they will generally be significantly less than the offsetting benefits. In order to prevent abuse, the Article proposes that secured creditors only be required to pay the expenses of the bankruptcy proceeding, including attorneys' fees, when the debtor's equity has first been exhausted.

This interpretation of section 506(c) is further supported by an application and understanding of game theory which demonstrates that financing attorneys' fees through the proceeds of secured collateral maximizes economic efficiency. Game theory illustrates situations, like the prisoners' dilemma in which the aggregation of self-interested individual actions fails to achieve a socially optimal result. The option presented to debtors and creditors between individual and collective collection remedies is analogous to the prisoners' dilemma because of the common pool problem. Game theory illustrates that, for both debtors and creditors, cooperation, through participation in the collective forum of bankruptcy, represents each individual party's optimal course of action as well as the socially or pareto optimal equilibrium. In sum, the benefits bankruptcy offers both the secured party and the debtor relative to other creditors' remedies suggests that, acting rationally, both parties will prefer bankruptcy and that the secured party should therefore accept the costs of the bankruptcy proceeding. This Article's formulation of section 506(c) is intended to facilitate recourse to bankruptcy's collective forum as the optimal solution.

