

# Barbarians at the Trough: Riposte in Defense of the Warren Carve-Out Proposal

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BARBARIANS AT THE TROUGH:  
RIPOSTE IN DEFENSE OF THE WARREN  
CARVE-OUT PROPOSAL

*Kenneth N. Klee*†

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INTRODUCTION

Secured creditors and their proxies in academia have proposed to expand the scope of the Article 9 personal property security inter-

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est to a practically unlimited scope.<sup>1</sup> With the check of a box, virtually all personal property can be encumbered.<sup>2</sup> The purported objective of the reform is to expand the extension of credit and increase its efficiency by lowering the transaction costs associated with secured credit.<sup>3</sup>

Critics have questioned whether expansion of the scope of Article 9 is necessary or wise.<sup>4</sup> Indeed, some commentators have questioned

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<sup>1</sup> See UNIFORM COMMERCIAL CODE REVISED ARTICLE 9 (Members Consultative Group Draft No. 2, Apr. 14, 1997) [hereinafter DRAFT REVISION] (on file with author). The American Law Institute's UCC Article 9 Drafting Committee prepared the Draft Revision. *Id.* Although the proposal expands the scope of the Article 9 personal property security interest, the Drafting Committee has strategically tempered that expansion to accommodate political interests that otherwise would oppose the proposal. Accordingly, the expanded Article 9 excludes personal injury tort recoveries and consumer deposit accounts from its scope. See *infra* note 2.

<sup>2</sup> The Draft Revision proposes to expand the reach of the Article 9 security interest to include all deposit accounts (excluding certain consumer accounts), tort claims (with the exceptions of after-acquired and personal injury tort claims), and medical insurance receivables. DRAFT REVISION, *supra* note 1, §§ 9-113, 9-304. Under the Draft Revision, the check of a box will be sufficient to perfect a blanket security interest in *all* property of a debtor to which an Article 9 security interest may attach, with the narrow exception of deposit accounts and certain securities-related assets. *Id.* at 22-23 (proposed § 9-111), 134-38 (proposed § 9-521 with financing statement form). With respect to those exceptions, however, a cursory description such as "all deposit accounts" or the like may extend the security interest. *Id.* at 22-23.

Inclusion of all deposit accounts, other than consumer deposit accounts, is intentional. The inclusion of blocked accounts, from which the debtor has no right of withdrawal without the lender's consent, is uncontroversial. On the other hand, the inclusion of operating deposit accounts, from which the debtor is free to make withdrawals at will, in the absence of default under the security documents, is quite controversial. See, e.g., Letter from Donald J. Rapson, Assistant General Counsel, CIT Group, to Professors Steven L. Harris and Charles W. Mooney, respectively of the Chicago-Kent College of Law and the University of Pennsylvania Law School (May 21, 1996) (on file with author).

<sup>3</sup> See Steven L. Harris & Charles W. Mooney, Jr., *A Property-Based Theory of Security Interests: Taking Debtors' Choices Seriously*, 80 VA. L. REV. 2021, 2021 (1994) ("[W]e take as our 'first principle' that Uniform Commercial Code Article 9 should facilitate the creation of security interests. Stated otherwise, we think the transfer of an effective security interest ought to be as easy, inexpensive, and reliable as possible."). Professors Harris and Mooney are the Reporters for the Permanent Editorial Board Article 9 Study Committee.

<sup>4</sup> See, e.g., Lynn M. LoPucki, *Chapter 11: An Agenda for Basic Reform*, 69 AM. BANKR. L.J. 573, 579 (1995); Memorandum from David Lander to Edwin E. Smith, Chair, and Members of the Article 9 Task Force (Oct. 27, 1995) (on file with author); Letter from Gerald K. Smith, Lewis and Roca LLP, to Edwin E. Smith, Chair, Article 9 Task Force (Oct. 24, 1995) (on file with author); Memorandum from Elizabeth Warren, Leo Gottlieb Professor of Law, Harvard Law School, to Edwin E. Smith, Chair, Article 9 Task Force, and Members of the Article 9 Task Force (Oct. 31, 1995) (on file with author); Audio tape of program on "The Unsecured Creditor and Article 9: Bambi Meets Godzilla Again and Is Better off Ex Ante," presented at the 1996 Annual Meeting of the Association of American Law Schools (Jan. 5, 1996) (on file with the Association of American Law Schools). As Professor Warren has noted, Professor Grant Gilmore, the principal draftsman of the original Article 9, presaged this debate and contributed his criticism over 15 years ago. In his last law review article, Professor Gilmore lamented the trend toward encumbering all of a debtor's property: "[D]oes it make any sense to award everything to a secured party who stands idly by while a doomed enterprise goes down the slippery slope into bankruptcy?" Grant Gilmore,

the efficiency of secured credit as an initial proposition.<sup>5</sup> The secured creditors' grab to expand the scope of Article 9 has sparked a reaction in academia and the practicing bar. Specifically, Professor Elizabeth Warren has suggested that Article 9 be amended to dedicate a portion of the secured party's collateral to repayment of judicial lien creditors.<sup>6</sup> Her Proposal is based on the suggestion by Professors Lucian Bebchuk and Jesse Fried that granting full priority to secured credit is inefficient because it captures values that belong to involuntary and less sophisticated creditors.<sup>7</sup>

Not surprisingly, the secured credit bar and commercial law professors have responded with a vengeance. They have attacked the Proposal for, *inter alia*, violating freedom of contract,<sup>8</sup> subverting the financing of small business,<sup>9</sup> and providing unsecured creditors with a basis to extort value from secured creditors.<sup>10</sup> This Article exposes the attacks for what they are: hysterical efforts to entrench wealth in the hands of banks, insurance companies, and finance companies at the expense of tort creditors, tax creditors, environmental creditors, and, perhaps, employees and trade creditors.

#### A. Burden of Proof Regarding Article 9 Expansion and the Proposal

We start by examining the burden of proof. Article 9 supporters believe proponents of the Warren Proposal bear the burden of proof on the Proposal as well as Article 9 reform. While Warren should bear the burden of proof on her Proposal, the Article 9 reformers should bear the burden of proof on the scope of Article 9 reform. If proponents of Article 9 reform believe expansion of its scope is justified, they should prove that efficiency gains will result.<sup>11</sup>

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*The Good Faith Purchase Idea and the Uniform Commercial Code: Confessions of a Repentant Draftsman*, 15 GA. L. REV. 605, 627 (1981).

<sup>5</sup> See, e.g., Lucian Arye Bebchuk & Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy*, 105 YALE L.J. 857, 872-79 (1996); David Gray Carlson, *On the Efficiency of Secured Lending*, 80 VA. L. REV. 2179 (1994).

<sup>6</sup> Memorandum from Elizabeth Warren, Leo Gottlieb Professor of Law, Harvard Law School, to the Council of the American Law Institute 1-2 (Apr. 25, 1996) [hereinafter Proposal] (on file with author) (regarding the Article 9 set aside for unsecured creditors).

<sup>7</sup> Bebchuk & Fried, *supra* note 5, at 880-95.

<sup>8</sup> See, e.g., Jeffrey S. Turner, *Should the Scope of an Article 9 Security Interest Be at All Limited? If So, How?* 1 (Oct. 31, 1995) (unpublished manuscript, on file with author).

<sup>9</sup> See, e.g., Letter from H. Bruce Bernstein, General Counsel, Commercial Finance Association, to Edwin Smith, Chairman, Article 9 Task Force 2-3 (June 6, 1996) (on file with author).

<sup>10</sup> See, e.g., Letter from Joel B. Zweibel, Partner, O'Melveny & Myers LLP, to Lucian A. Bebchuk & Jesse Fried, Professors, Harvard Law School 8-9 (Oct. 18, 1996) (on file with author).

<sup>11</sup> See, e.g., Letter from Howard Ruda, Counsel, Hahn & Hessen LLP, to Geoffrey C. Hazard, Jr., Professor, University of Pennsylvania Law School 3-4 (May 22, 1996) (on file with author); Steven L. Schwarcz, *The Easy Case for the Priority of Secured Claims in Bankruptcy*,

## B. Efficiency

It is doubtful that expanding the scope of Article 9 will result in net efficiency gains. While the case can be made that expansion of the scope of Article 9 will create efficiency gains in some projects, the opposite will be true with respect to other projects. As a matter of course, secured lenders have the upper hand in negotiating secured transactions. Except in the largest transactions, there is no negotiation with the debtor over the boilerplate language in the financing documents. If proponents successfully expand the scope of Article 9, secured lenders can be expected to take all personal property collateral as a matter of course. Yet the borrowing base will not increase with respect to many categories of collateral, including operating deposit accounts. As a result, the dollar amount of the debtor's consensual unsecured credit should contract or become more expensive because it is more risky. Moreover, the debtor's nonconsensual unsecured creditors will bear additional risks without compensation for those risks. In addition, the debtor's ability to reorganize will be reduced, because it will have no free and clear assets with which to operate or fund a plan of reorganization once its secured loan is in default.

Professor Elizabeth Warren has proposed counteracting the suggested expansion of the scope of Article 9 by permitting judicial lien creditors to surcharge up to 20% of the value of the collateral.<sup>12</sup> Professor Jay Westbrook has suggested a similar approach, but only in the event that the debtor is insolvent or bankrupt.<sup>13</sup> Secured creditors, their attorneys, and their sympathizers in academia have responded with predictable outrage. Stripping away the rhetoric and hyperbole from their attacks, we face fundamental theoretical questions about both the suggested reform of Article 9 and the Proposal. Is the extension of secured credit beneficial, and if so, are there limits on the truth of this proposition?

Article 9 proponents love secured credit.<sup>14</sup> Secured credit is said to lower the debtor's borrowing costs and to provide liquidity to enable the debtor to avoid bankruptcy.<sup>15</sup> The debtor's unsecured creditors are thought to be free-riding beneficiaries of this process.<sup>16</sup> On

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47 DUKE L.J. (forthcoming Dec. 1997) (manuscript at 4, on file with author) ("The burden of regulation [to limit the priority or scope of an Article 9 security interest] therefore should be on its advocates to show, by persuasive empirical evidence, that unsecured creditors need protection, a burden that has not been met.").

<sup>12</sup> Proposal, *supra* note 6, at 1.

<sup>13</sup> Memorandum from Jay L. Westbrook, Benno C. Schmidt Chair of Business Law, University of Texas School of Law, to Geoffrey Hazard, Director of The American Law Institute 5-6 (Sept. 4, 1996) (on file with author).

<sup>14</sup> See, e.g., Schwarcz, *supra* note 11.

<sup>15</sup> See *id.* (manuscript at 4-6).

<sup>16</sup> See *id.*

the other hand, skeptics counter these contentions with some force. If secured credit is such a panacea, why do some creditors extend unsecured credit voluntarily? Surely the market must recognize that there are transaction costs that make security interests inefficient for large categories of lenders. If secured credit actually reduces a debtor's borrowing costs, why do debtors seek unsecured credit? Perhaps debtors recognize that secured credit typically is much more restrictive on the debtor's business operations than is unsecured credit.

Considering the problem as an issue of corporate finance provides useful insights. The debtor's weighted average after tax<sup>17</sup> cost of capital (WACC) is computed by multiplying the volume of capital times its percentage cost for each component of the capital structure, and dividing by total capital.<sup>18</sup> Thus, if a debtor's capital structure comprises \$500,000 of secured debt costing 10% annually, \$300,000 of unsecured debt costing 16% annually, and \$200,000 of equity capital from which investors demand a 20% annual rate of return, the WACC is 13.8% ( $((\$500,000 \times 10\%) + (\$300,000 \times 16\%) + (\$200,000 \times 20\%)) \div \$1,000,000$ ). Secured credit enthusiasts contend that if such a debtor can obtain additional secured credit at less than 13.8%, the debtor will reduce its WACC. However, the WACC will be reduced only if the costs of unsecured credit and equity capital do not adjust, either because (i) these costs are fixed and cannot adjust or (ii) there is no relative increase in risk that warrants adjustment. If unsecured credit and equity capital costs do not adjust because there is no relative increased risk, then the marginal extension of secured credit is beneficial (or at least not harmful). Nevertheless, if risk for the unsecured creditors increases, then the extension of secured credit is not beneficial, because either it will be offset by adjustment, or increased risk will be borne by nonadjusting creditors.

Of course, it is possible that the benefits to the debtor, its employees, and society at large that will derive from the extension of secured credit outweigh the detriments to unsecured creditors. That is, the marginal extension of secured credit may be Kaldor-Hicks efficient, even if it is not Pareto superior.<sup>19</sup> But that is precisely the focus of the

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<sup>17</sup> The after-tax cost of capital should be used in order to credit any tax benefit that the debtor receives from a specific kind of financing. For example, if (1) the pre-tax cost of the debtor's unsecured debt financing is 20%, (2) the debtor is in a marginal combined income tax bracket of 40%, and (3) the debtor can utilize a deduction for interest paid or accrued on the unsecured indebtedness to offset taxable income, then the after-tax cost of unsecured debt capital is actually 12% ( $.20 - (.4 \times .20)$ ).

<sup>18</sup> See generally MARK S. SCARBERRY ET AL., BUSINESS REORGANIZATION IN BANKRUPTCY 781-85 (1996) (explaining calculation of the cost of capital).

<sup>19</sup> For the extension of secured credit to be Pareto superior, the extension of secured credit must make the secured creditor better off without making unsecured creditors worse off. See Jules L. Coleman, *Efficiency, Utility, and Wealth Maximization*, 8 HOFSTRA L. REV. 509, 512-13 (1980). For the extension of secured credit to be Kaldor-Hicks efficient,

Proposal, which endeavors to compensate unsecured creditors for exposure to increased risks.

Economists disagree whether there is one optimal capital structure, multiple optimal structures, or infinite optimal structures.<sup>20</sup> Until we know the answer to this issue, we cannot be certain whether incremental secured credit will always be balanced by adjustments to debt and equity capital, or whether it will move a debtor toward (or away from) an optimal structure. We can be certain, however, that granting a secured creditor excess collateral cannot benefit the debtor unless it is accompanied by lower borrowing costs or a larger extension of credit (except perhaps to the extent that the excess collateral may "shield" the debtor's property from levy by a third-party creditor). By comparison to current law, the suggestion to expand Article 9 to allow secured creditors to encumber virtually all personal property by checking a box is certain to be detrimental in numerous circumstances. For example, it is doubtful that secured creditors will increase credit availability or reduce borrowing costs based on the encumbrance of the debtor's litigation recoveries and operating bank accounts. These kinds of collateral offer a secured creditor a potential reduction of its deficiency in the event of default, but are too variable to alter a lender's credit decision. Thus, in the event of default, the secured creditor receives a random benefit, while the debtor and unsecured creditors are deprived of the very assets that may finance rehabilitation of the business.<sup>21</sup>

#### RIPOSTE TO MACROCRITICISMS OF THE PROPOSAL

To counteract the secured creditor's pervasive lien, the Proposal preserves some values for both the debtor's unsecured creditors and,

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the benefits to the secured creditor and the debtor need only outweigh the harm to unsecured creditors. See generally RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 13-14 (4th ed. 1992) (explaining and providing an example of Kaldor-Hicks efficiency).

<sup>20</sup> For example, traditional economists would contend that application of the Modigliani-Miller hypothesis to an extension of secured credit would result in the cost savings from secured credit being matched by an identical increase in the cost of unsecured credit. See Alan Schwartz, *The Continuing Puzzle of Secured Debt*, 37 VAND. L. REV. 1051, 1054 (1984). Law-and-economics scholars might contend that secured credit would provide a net gain because involuntary or nonadjusting unsecured creditors cannot compensate for the increased risk to them imposed by an extension of secured credit. See, e.g., Paul M. Shupack, *Solving the Puzzle of Secured Transactions*, 41 RUTGERS L. REV. 1067, 1106-07 (1989). Contemporary law-and-economics scholars might contend that the extension of new money secured credit increases the debtor's liquidity, thereby reducing the risk of its bankruptcy and increasing the value for all concerned, including the unsecured creditors. See Schwarcz, *supra* note 11 (manuscript at 5-6).

<sup>21</sup> This type of random benefit has led some Article 9 aficionados to argue that an unperfected lienholder should defeat a judicial lien creditor by reversing priorities under UCC § 9-301(1). See James J. White, *Revising Article 9 to Reduce Wasteful Litigation*, 26 LOY. L.A. L. REV. 823, 823-24 (1993).

derivatively, the debtor's bankruptcy trustee. Specifically, the Proposal permits a levying creditor to realize on execution up to 20% of the value of a secured creditor's collateral.<sup>22</sup> Functionally, the secured creditor's lien is shared *pari passu* with the levying creditor (or bankruptcy trustee) up to 20% of the value of the collateral.<sup>23</sup> This process repeats for each levying unsecured creditor.<sup>24</sup>

Others writing articles in this Symposium will justify the need for the Proposal, explain the intricacies of the Proposal, debate whether it should apply only on the debtor's insolvency or in bankruptcy, and respond to technical critiques of the Proposal. By contrast, this Article serves as a riposte to some of the loudest broad-based criticisms of the Proposal.

#### A. Criticism Number 1: The Proposal Will Contract Credit Thereby Inhibiting Growth and Causing Business Failures

To some extent, the Proposal will deleverage American business. In some cases, secured creditors will extend less secured credit to the debtor because the Proposal's 20% surcharge will be factored into the borrowing base. Under current law, lenders reduce the amount of credit extended to take account of creditors who receive priority over secured creditors under nonbankruptcy laws.<sup>25</sup> Although, in many cases, the decrease in secured borrowing will be offset by increased extension of unsecured credit, in some cases there will be a net decrease in credit available to the debtor. For example, where the debtor is in a risky start-up venture or on the verge of insolvency, the risk to unsecured creditors might be so great that instead of seeking a high interest rate to compensate for increased risk, they simply will not extend new credit. The resulting liquidity crisis will force the debtor into bankruptcy, where unsecured creditors will recover less than if the debtor had not filed. Therefore, critics oppose the Proposal because it hurts marginal businesses and will cause more bankruptcies.

The critique is correct. At the margin, the Proposal will cause a deleveraging of American business and more bankruptcies, but these

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<sup>22</sup> Proposal, *supra* note 6, at 1 (suggesting the adoption of a new U.C.C. § 9-301(5)).

<sup>23</sup> The trustee in bankruptcy would obtain the status of a hypothetical levying creditor for the entire amount of unsecured claims against the debtor. See 11 U.S.C. § 544(a)(1) (1994); *infra* note 30.

<sup>24</sup> Proposal, *supra* note 6, at 2 (discussion of sequential liens).

<sup>25</sup> For example, lenders restrict the availability of credit to distributors of produce whose inventory is subject to statutory liens of producers under the Perishable Agricultural Commodities Act of 1930, 7 U.S.C. § 499e(c) (1994) (amended 1995). See Letter from H. Bruce Bernstein to Edwin Smith, *supra* note 9, at 2.

results are not necessarily undesirable.<sup>26</sup> Under current law, overleveraged businesses attract unsecured credit without justly compensating unsecured creditors for risk. Tort creditors cannot adjust to compensate for the increased risk. Other creditors that theoretically are capable of adjusting for increased risk often cannot afford the transaction costs to monitor the debtor to determine such risk. Employees, consumer customers, and small vendors fall into this category. Even if these creditors become aware of the risk, some lack the bargaining power to adjust for it. For example, a vendor whose only customer is the debtor is unlikely to adjust by changing credit terms or suspending shipping.<sup>27</sup> Likewise, the debtor's employees are unlikely to quit their jobs even if they fail to negotiate increased benefits.<sup>28</sup>

Critics assume that because these nonadjusting unsecured creditors will receive little in bankruptcy, they will prefer that the debtor obtain more secured credit to avoid bankruptcy.<sup>29</sup> This critique is static, and ignores the possibility that a greater extension of secured credit will not forestall a later bankruptcy. In the interim, creditors who extend unsecured credit to the debtor might well be worse off than if they had extended this credit in a bankruptcy case—in which they would enjoy at least an administrative expense priority claim for the credit.

These critics also ignore the secured creditor's incentive to avoid bankruptcy. Often, a secured creditor will manage a debtor's liquidity crisis to maximize the value of collateral by collecting accounts receivable and selling inventory in the ordinary course of business. Concurrently, the secured creditor will reduce its credit risk by reducing advance rates, deferring capital expenditures, imposing cost controls, and demanding equity infusions or reductions in insider benefits. Although these actions may serve to maximize the value recovered by the secured creditor, they may not reduce the risk of bankruptcy.

The Proposal will increase the secured creditor's incentive to help the debtor avoid bankruptcy, particularly because the secured

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<sup>26</sup> See Bebhuk & Fried, *supra* note 5, at 917-21 (arguing that a "partial-priority rule is more likely to prevent the financing of an inefficient activity than an efficient one").

<sup>27</sup> In the author's experience during Chrysler corporation's 1979-80 restructuring, certain Chrysler parts manufacturers continued to ship parts even in the face of increased risk.

<sup>28</sup> In an analogous context, Professor Ronald Mann has observed and analyzed the relative inability of contractors that extend labor and materials to real estate developers on credit to adjust for increased risk (as compared to construction lenders). Ronald J. Mann, *The First Shall Be Last: A Contextual Argument for Abandoning Temporal Rules of Lien Priority*, 75 TEX. L. REV. 11, 23-42 (1996). Based on these observations, Professor Mann has proposed a uniform rule that would consistently subordinate the claims of construction lenders to those of contractors. *Id.* at 13-14.

<sup>29</sup> See, e.g., Schwarcz, *supra* note 11 (manuscript at 5-6).

creditor is certain to lose 20% of the value of its collateral in a bankruptcy case.<sup>30</sup> Moreover, the threat of a levy by an unpaid, unsecured creditor will cause even the oversecured creditor to monitor the debtor more closely than under current law. Because the Proposal will render part of the secured creditor's claim unsecured, the secured creditor will have the proper incentive to act efficiently, rather than sacrifice asset values to maximize its secured position, as under current law.

B. Criticism Number 2: If the Proposal Taxes Article 9 Security Interests, Creditors Will Use Other Forms of Financing to Avoid the Tax

Critics claim that even if a collateral surcharge is warranted, creditors will avoid the tax by engaging in other forms of financing.<sup>31</sup> To some extent, the critics are correct. Under current law, disparities in treatment cause financiers to engage in alternatives to secured transactions such as, *inter alia*, swaps, repurchase agreements, financing trusts, sale-leaseback transactions, sales, securitization transactions, and lease agreements.<sup>32</sup> Article 9 could be reformed, however, to treat each of these transactions as a secured transaction when recharacterization is appropriate.<sup>33</sup> Alternatively, state legislators could regulate these forms of financing in a manner similar to an Article 9 security interest. For example, under current law, most sales of accounts are subject to Article 9.<sup>34</sup> Similar changes could be made to

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<sup>30</sup> The secured creditor will lose 20% of its collateral to the trustee in bankruptcy based on the trustee's status as a hypothetical judicial lien creditor. See 11 U.S.C. § 544(a)(1) (1994) (giving the trustee the status of a hypothetical judicial lien creditor). If the allowed unsecured claims in the bankruptcy case total less than 20% of the value of the collateral, the trustee may be limited to asserting lien status to the extent of allowed unsecured claims. Compare, e.g., *Whiteford Plastics Co. v. Chase Nat'l Bank*, 179 F.2d 582 (2d Cir. 1950) (trustee could not avoid lien where unsecured creditors had received all distributions provided under confirmed plan of arrangement and therefore creditors would not "benefit" from avoidance), with *Acequia, Inc. v. Clinton (In re Acequia, Inc.)*, 34 F.3d 800, 811-12 (9th Cir. 1994) (trustee may avoid transfer notwithstanding the payment of unsecured creditors' claims in full under confirmed plan of reorganization, as long as avoidance may benefit the estate of a whole).

<sup>31</sup> See, e.g., Lisa M. Bossetti & Mette H. Kurth, *Professor Elizabeth Warren's U.C.C. Article 9 Carve-Out Proposal: A Strategic Analysis*, 30 UCC L.J. 3, 7-17 (1997); Schwarcz, *supra* note 11 (manuscript at 62-63); Memorandum from Jeffrey S. Turner, Partner, Brobeck Phleger & Harrison LLP to Members of the Article 9 Task Force 7 (June 3, 1996) (on file with author); Letter from James J. White, Professor, University of Michigan Law School, to Edwin E. Smith, Chair, Article 9 Task Force 5 (June 3, 1996) (on file with author). But see *Bebchuk & Fried, supra* note 5, at 926-29 (discussing inefficiencies of leasehold as an alternative form of financing).

<sup>32</sup> For example, the Bankruptcy Code grants special rights to a nondebtor party to a swap or repurchase transaction. See 11 U.S.C. §§ 559-560 (1994).

<sup>33</sup> Cf. *Bebchuk & Fried, supra* note 5, at 928-29 (suggesting less favorable treatment of lessors in bankruptcy as a means of discouraging circumvention of partial priority rule).

<sup>34</sup> See U.C.C. § 9-102(1)(b) (1994).

state mortgage laws to solve the problem with respect to real property financing. Indeed, under current law, some states give priority to nonadjusting environmental creditors ahead of the liens of mortgagees.<sup>35</sup> Finally, Congress could amend the Bankruptcy Code to let bankruptcy judges use equity powers<sup>36</sup> to pierce through the form of alternative financings where they are really secured financings in substance.<sup>37</sup> But in order to encourage out-of-court restructurings with lower transaction costs than bankruptcy, responsible state legislators should invest such powers in state judges under state law.

Secured creditors and their apologists will howl with anguish at the suggestion that courts be permitted to deal with substance over form. They will insist that granting discretion to the judiciary to do justice will create uncertainty in financing transactions and increase borrowing costs. Critics have used similar scare tactics to attack equitable subordination, lender liability, and other equitable powers that courts use to counter a rapacious secured creditor's overreaching.<sup>38</sup> Secured creditors live with some uncertainty today, and they will live with it tomorrow. However, the proposal will also create certainty. In keeping with the finest tradition of the common law,<sup>39</sup> as long as the secured creditor has assets in the United States or is subject to the personal jurisdiction of United States courts, the judge will be able to look to the substance of the transaction to do justice.

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<sup>35</sup> See, e.g., CONN. GEN. STAT. § 22a-452a (1995); LA. REV. STAT. ANN. § 30:2281 (West Supp. 1997); ME. REV. STAT. ANN. tit. 38, § 1371 (West 1989 & Supp. 1996); MASS. GEN. L. ch. 21E, § 13 (1996); N.H. REV. STAT. ANN. § 147-B:10-b (1996 & Supp. 1996); N.J. REV. STAT. § 58:10-23.11f(f) (1992).

<sup>36</sup> The Bankruptcy Code grants the bankruptcy judge power to "issue any order, process, or judgment that is necessary or appropriate" to carry out the Bankruptcy Code. 11 U.S.C. § 105(a) (1994). Congress intended that this grant of power be equivalent to the All Writs Act, 28 U.S.C. § 1651 (1994). See H.R. REP. No. 95-595, at 175 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6135 (stating that "[t]he bankruptcy court has ample additional power to prevent damage to the bankrupt estate by such actions on a case-by-case basis") (citing what is now codified as 11 U.S.C. § 105 (1994) and 28 U.S.C. § 1651 (1994)). However, appellate courts have circumscribed this broad grant of power. See, e.g., *United States v. Pepperman*, 976 F.2d 123, 131 (3d Cir. 1992); *Bird v. Carl's Grocery Co.* (*In re* NWFX Inc.), 864 F.2d 593, 595 (8th Cir. 1989); *United States v. Sutton*, 786 F.2d 1305, 1308 (5th Cir. 1986).

<sup>37</sup> Courts often recharacterize transactions as secured loans. See, e.g., *Pacific Express, Inc. v. Teknekron Infoswitch Corp.* (*In re* Pacific Express, Inc.), 780 F.2d 1482, 1484-85 (9th Cir. 1986); *Adelman v. General Motors Acceptance Corp.* (*In re* Tulsa Port Warehouse Co.), 690 F.2d 809, 811-12 (10th Cir. 1982).

<sup>38</sup> See, e.g., Laura Lin, *The Information Content of a Bank's Involvement in Private Workouts*, 3 GEO. MASON INDEP. L. REV. 97, 118-22 (1994); Scott M. Browning, Note, *No Fault Equitable Subordination: Reassuring Investors That Only Government Penalty Claims Are at Risk*, 34 WM. & MARY L. REV. 487 (1993); Mark Snyderman, Comment, *What's So Good About Good Faith? The Good Faith Performance Obligation in Commercial Lending*, 55 U. CHI. L. REV. 1335, 1337-38 (1988).

<sup>39</sup> See *Bank of Marin v. England*, 385 U.S. 99, 103 (1966); *Pepper v. Litton*, 308 U.S. 295, 303-04 (1939).

C. Criticism Number 3: The Proposal Infringes on Freedom of Contract and Constitutes an Unconstitutional Taking of Private Property for Public Use Without Just Compensation

Critics attack the Proposal as an unwarranted regulation of the free market, alienability of property, and freedom of contract.<sup>40</sup> Some even suggest that the Proposal raises Fifth Amendment takings issues.<sup>41</sup>

The freedom of contract argument is a makeweight. Market proponents claim that the debtor should be able to determine without governmental restraint whether to incur credit. This argument assumes that the only interests affected by the contract are those of the debtor and secured creditor, and that unsecured creditors can decide not to extend credit to a debtor whose assets are fully encumbered.

However, the secured credit contract also affects the interests of nonadjusting creditors that are not at the bargaining table when the contract is negotiated.<sup>42</sup> As a result, the debtor bargains away its interests for the benefit of the secured creditor. The Proposal remedies this defect by exposing the secured creditor to the risk of holding an unsecured deficiency claim,<sup>43</sup> thereby giving the secured creditor an incentive to act in the interests of all creditors (except for perhaps subordinated debtholders).<sup>44</sup> Regulation is warranted precisely because the tort and other nonadjusting creditors lack the legal capacity or practical ability to protect themselves. On reflection, law and public policy should require regulation of these contracts.

The takings argument is likewise a makeweight. To the extent the Proposal is prospective, there is no takings issue.<sup>45</sup> All future liens will be extended under a state law that provides a carve out for levying creditors. To the extent the Proposal is retroactive, however, a taking might not exist because the lien might be regarded as a contract right

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<sup>40</sup> See, e.g., Turner, *supra* note 31, at 2-3, 8.

<sup>41</sup> See Memorandum from Jeffrey S. Turner to Members of the Article 9 Task Force, *supra* note 8, at 3 n.2.

<sup>42</sup> See Bebchuk & Fried, *supra* note 5, at 932-34 (discussing freedom of contract critique and stating that "when the contract directly impinges on the rights of third parties, there is no prima facie presumption of freedom of contract").

<sup>43</sup> The Proposal ameliorates the risk that a fully secured creditor will become undersecured by permitting secured creditors to require lien creditors to marshal against unencumbered assets. Proposal, *supra* note 6, at 1.

<sup>44</sup> The deficiency claim of the secured creditor would be treated *pari passu* with general unsecured claims, but would be senior to any unsecured claim that is subordinated generally or is subordinated to debts for money borrowed. See generally 11 U.S.C. §§ 506(a), 510, 726(b), 1129 (1994) (detailing a similar statutory scheme).

<sup>45</sup> See, e.g., *United States v. Security Indus. Bank*, 459 U.S. 70 (1982); *Ogden v. Saunders*, 25 U.S. (12 Wheat.) 213 (1827).

or interest in property, rather than property itself.<sup>46</sup> But under state law, the Proposal cannot be applied retroactively because to do so would constitute an impairment of obligation under contract, in violation of the Constitution.<sup>47</sup> Of course, the Contracts Clause does not constrain Congress,<sup>48</sup> which could provide for retroactive application of the Proposal under the Commerce Clause.<sup>49</sup> Nevertheless, Congress is unlikely to do so because of the politics of federalizing commercial law and the potential for takings litigation that such legislation would spawn.<sup>50</sup>

#### D. Criticism Number 4: The Proposal's Use of 20% Is Arbitrary and Will Hurt Several Forms of Financing

Of course, the Proposal's selection of 20% is arbitrary, but only to the extent that it reflects the exercise of discretion. In no way is the 20% figure unreasonable or unprecedented. By way of comparison, Germany imposes a cumulative 9% surcharge against collateral to permit the estate to recoup costs from collateral sold in bankruptcy proceedings.<sup>51</sup> In addition, under German law, the secured lender must pay a 15% turnover tax on the sale of collateral in insolvency proceed-

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<sup>46</sup> See Steve H. Nickles, *Consider Process Before Substance, Commercial Law Consequences of the Bankruptcy System: Urging the Merger of the Article 9 Drafting Committee and the Bankruptcy Commission*, 69 AM. BANKR. L.J. 589, 593-94 & n.12 (1995). Cf. XL/Datacomp, Inc. v. Wilson (*In re Omegas Group, Inc.*), 16 F.3d 1443, 1451 (6th Cir. 1994) (holding that, under state law, a constructive trust was only a remedy rather than a property right that would override ratable distribution in bankruptcy).

<sup>47</sup> The Contracts Clause provides that "[n]o State shall . . . pass any . . . Law impairing the Obligation of Contracts." U.S. CONST. art. I, § 10, cl. 1; cf. *Sturges v. Crowninshield*, 17 U.S. (4 Wheat.) 122 (1819) (precluding state insolvency laws from applying retroactively to debts incurred before enactment, based on Contracts Clause concerns).

<sup>48</sup> The Commerce Clause provides that the Congress shall have the power "To regulate Commerce with foreign Nations, and among the several States . . ." U.S. CONST. art. I, § 8, cl. 3.

<sup>49</sup> See, e.g., *Continental Ill. Nat'l Bank & Trust Co. v. Chicago, Rock Island & Pac. Ry. Co.*, 294 U.S. 648, 680 (1935) (holding that "Congress . . . has authority to pass legislation pertinent to any of the powers conferred by the Constitution, however it may operate collaterally or incidentally to impair or destroy the obligation of private contracts").

<sup>50</sup> Federal regulation of matters affecting commerce has a long history of inviting constitutional challenge under the Takings Clause of the Fifth Amendment. See, e.g., *Ruckelshaus v. Monsanto Co.*, 467 U.S. 986 (1984) (challenging pesticide registration scheme imposed by Federal Insecticide, Fungicide, and Rodenticide Act); *Hodel v. Indiana*, 452 U.S. 314 (1981) (challenging federal regulation of coal mining under Surface Mining Control and Reclamation Act of 1977); *Andrus v. Allard*, 444 U.S. 51 (1979) (challenging prohibition on sale of eagle and bird artifacts under Eagle Protection and Migratory Birds Treaty Acts); *Highland v. Russell Car & Snow Plow Co.*, 279 U.S. 253 (1929) (challenging federal fixing of coal prices under Lever Act).

<sup>51</sup> *Insolvenzordnung (InsO) [Insolvency Statute]*, 5.10.1994 (BGB.I. S.2866), § 171. Subsection (1) assesses a 4% charge as a cost of determination of the collateral. Subsection (2) assesses a 5% charge as a cost of disposition of the collateral. These costs are assessed against the collateral *in rem*. See *id.*

ings, for a total possible cost to the secured party of 24%.<sup>52</sup> The 20% number in the Proposal is reasonable by comparison; moreover, it should be large enough to affect secured creditors in making credit decisions and provide a meaningful pot for unsecured creditors or the bankruptcy trustee. Thus, monitoring by secured creditors will improve the efficiency of secured lending, and the residual pot will facilitate rehabilitation if the debtor defaults.

Nevertheless, the 20% figure may not work for all forms of financing. Some fine-tuning may be necessary based on actual experience. At this juncture, it might be prudent to consider modifying the Proposal to exclude its application to purchase money financing, as long as the secured creditor takes no other collateral. Moreover, the Proposal probably should not apply to financial services debtors such as banks, credit unions, stock brokerages, and the like, where high loan-to-value ratios are the norm<sup>53</sup> and the presence of nonadjusting creditors is insignificant or remote.<sup>54</sup> However, for the manufacturing or nonfinancial services debtor, the Proposal should be applied as drafted.

#### E. Criticism Number 5: The Proposal Will Defeat Uniformity and Lead to a Race to the Bottom

Critics contend that the Proposal will not be adopted as a uniform state law.<sup>55</sup> Therefore, secured creditors will force debtors to reincorporate in states that refuse to adopt the Proposal. This will create a race to the bottom and discourage legislatures from adopting the Proposal.

The uniformity concern is an important issue under existing law. To the extent commercial law is nonuniform, perhaps it should be federalized.<sup>56</sup> That way, Congress could use the Commerce Clause<sup>57</sup> to enact uniform commercial laws that balance commercial law and bankruptcy law issues.

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<sup>52</sup> *Id.* § 171(2). If the collateral is sufficient, the surplus will fund the 9% costs under § 171.

<sup>53</sup> *See, e.g.*, Letter from H. Bruce Bernstein to Edwin Smith, *supra* note 9, at 2 n.2.

<sup>54</sup> Financial institutions do not normally face large numbers of tort claims. They do have numerous small, unsophisticated creditors (depositors or customers) to which regulatory law grants priority or protection. *See* 12 U.S.C. § 1821(a)(1) (1994) (guaranteeing up to \$100,000 insurance for a depositor at an FDIC-insured institution).

<sup>55</sup> *See, e.g.*, Letter from Howard Ruda to Geoffrey C. Hazard, *supra* note 11, at 4 (“[I] wonder whether a non-uniform enactment of the 20% Rule would result in the non-enacting states offering (or seeming to offer) a more congenial borrowing environment to the business community.”); Turner, *supra* note 8, at 3 (“[N]on-uniformity would be sure to prevail on this point.”).

<sup>56</sup> *See* Nickles, *supra* note 46, at 595 (“Whether federalizing commercial law is good or bad depends, ultimately, on whether the federal legislative process is ‘better’ than the uniform laws process.”).

<sup>57</sup> *See supra* notes 48-50 and accompanying text.

In the meantime, current commercial law is nonuniform.<sup>58</sup> For example, some states permit deposit accounts to be subject to Article 9 security interests, while others do not.<sup>59</sup> Yet there is no empirical evidence that creditors have abandoned financing in states where deposit accounts cannot be taken as Article 9 collateral.<sup>60</sup> Nor is it contended that financing costs are higher in such states.<sup>61</sup> In fact, the differences in commercial law permit the states to serve as laboratories in which to experiment with improvements in commercial law on a trial basis.<sup>62</sup> In the short run, the best way to test the Proposal in practice would be to compare data in a nonuniform environment. This comparison should happen naturally as different state legislatures proceed at different rates to adopt the Proposal. Theoretically, if the Proposal proves to maximize social welfare, more states will adopt it; if not, the Proposal will disappear from the books.

F. Criticism Number 6: The Proposal Is Based on the Flawed Premise that Debtors and Secured Creditors Collude to Perpetuate the Longevity of Failing Businesses to the Detriment of Unsecured Creditors

Critics of the Proposal contend that secured creditors and debtors have no reason to collude to support failing businesses.<sup>63</sup> They argue that secured creditors have no incentive to overleverage a borrower or to lend to a debtor that is highly likely to default. By the same token, the argument continues, debtors have no incentive to overcollateralize their secured creditors, because unsecured creditors

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<sup>58</sup> See JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE § 1, at 7 (3d ed. 1988) ("As early as 1967, the various jurisdictions enacting the Code had made approximately 775 separate amendments to it. Article Nine on security interests in personal property was the chief victim of the nonuniform amendments.") (citations omitted).

<sup>59</sup> Compare CAL. COM. CODE § 9302(1)(g) (West 1990 & Supp. 1997); 810 ILL. COMP. STAT. ANN. 5/9-302(i) (Supp. 1997) (permitting a secured party to take an Article 9 security interest in deposit accounts), with N.Y. U.C.C. LAW § 9-104(l) (McKinney 1990) (excluding from Article 9 a transfer of an interest in any deposit account except with respect to proceeds and priorities in proceeds); 13 PA. CONS. STAT. ANN. § 9104(12) (West 1984) (same); TEX. BUS. & COM. CODE ANN. § 9.104(12) (West 1991) (same).

<sup>60</sup> Indeed, my own experience is that New York law is selected frequently as the law of choice in many public and private financings.

<sup>61</sup> Despite all of the talent on the Article 9 Drafting Committee, the Committee has made no effort to collect empirical data comparing the cost of financing in Article 9 jurisdictions that permit the encumbrance of deposit accounts with those that do not.

<sup>62</sup> See, e.g., Mann, *supra* note 28, at 31-42 (noting the relative advantages of state laws that subordinate construction lenders' liens to contractors' liens); Edwin E. Smith, Should the Scope of an Article 9 Security Interest Be Limited? If So, How? 2 (Oct. 31, 1995) (unpublished manuscript, on file with author) (where a state has adopted a non-uniform amendment "we should review that state's experience to see what guidance it may provide").

<sup>63</sup> See, e.g., Letter from H. Bruce Bernstein to Edwin Smith, *supra* note 9, at 1-2; Letter from Jeffrey S. Turner to Members of the Article 9 Drafting Committee, *supra* note 31, at 4-5.

would refuse to extend trade credit in those circumstances. These arguments prove too much and, in some cases, are mistaken.

Secured creditors have several reasons to engage in a highly leveraged transaction. The leveraged buyout cases of the 1980s bear witness to the damage that fee-driven lending can cause.<sup>64</sup> Specifically, banks and other financial institutions made unsound loans based on euphoric projections that had little chance of occurring.<sup>65</sup> Bank officers booked lucrative short term fees.<sup>66</sup> If the risky transactions paid off, the bank did well and the bank's senior officers profited through the increased value of their stock options. If the loans failed, the bank officers could move on to another job. If the bank itself failed, the FDIC and American taxpayers could bail out the bank's depositors.<sup>67</sup> The debtor's selling shareholders profited handsomely by receipt of value in the leveraged buyout.<sup>68</sup> Existing unsecured creditors were exposed to increased risks, as were nonadjusting future creditors.

Some secured lenders engage in "asset-based" lending of a pernicious character. They lend on a secured basis at high interest rates to marginal debtors and also obtain a personal guarantee secured by the debtor's president's personal assets and stock in the business. The amount loaned is not quite enough to let the debtor survive. Covenants are so tight that the slightest slip in future performances places the debtor in default. If the debtor pays, the lender receives a handsome return on investment. If the debtor defaults, the lender takes control of the business and either liquidates the assets or operates the business as a going concern. Thus, the personal guarantee acts as insurance against the debtor filing a voluntary Chapter 11 case.

History teaches us that collusion arises in the workout context where the lender both engages in a friendly foreclosure to squeeze

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<sup>64</sup> See, e.g., *Kaiser Steel Corp. v. Pearl Brewing Co.* (*In re Kaiser Steel Corp.*), 952 F.2d 1230 (10th Cir. 1991); *United States v. Tabor Court Realty Corp.*, 803 F.2d 1288 (3d Cir. 1986); *Murphy v. Meritor Sav. Bank* (*In re O'Day Corp.*), 126 B.R. 370 (Bankr. D. Mass. 1991); *Wieboldt Stores, Inc. v. Schottenstein*, 94 B.R. 488 (N.D. Ill. 1988).

<sup>65</sup> See, e.g., *O'Day Corp.*, 126 B.R. at 379-81, 405-09 (investment banker and bank officer proceeded to finance LBO based upon unrealistic projections, ignoring substantial available information indicating the debtor's financial decline).

<sup>66</sup> See, e.g., *Mellon Bank v. Metro Communications, Inc.*, 945 F.2d 635, 646 (3d Cir. 1991); Bernard S. Black, *The Value of Institutional Investor Monitoring: The Empirical Evidence*, 39 UCLA L. REV. 895, 924 n.131 (1992); John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor As Corporate Monitor*, 91 COLUM. L. REV. 1277, 1315 & n.160 (1991); Charles M. Elson, *Fairness Opinions: Are They Fair or Should We Care?*, 53 OHIO ST. L.J. 951, 965-68 (1992); Martin Lipton & Steven A. Rosenblum, *A New System of Corporate Governance: The Quinquennial Election of Directors*, 58 U. CHI. L. REV. 187, 223 & n.111 (1991); James F. Queenan, Jr., *The Collapsed Leveraged Buyout and the Trustee in Bankruptcy*, 11 CARDOZO L. REV. 1, 3 (1989).

<sup>67</sup> See *supra* note 54; see also 12 U.S.C. § 1821(f) (1994) (providing mechanism for payment of depositors in insured financial institutions that are liquidated or closed).

<sup>68</sup> See, e.g., *Kaiser Steel*, 952 F.2d at 1237-40 (permitting selling shareholders to retain LBO payments as "settlement" payments).

out unsecured creditors and gives the debtor's managers long term contracts to operate the foreclosed business. The equity receivership cases of the early twentieth century typify this kind of collusion.<sup>69</sup> Although the Bankruptcy Code was designed to preclude this result, the practice persists regarding small businesses whose creditors are unlikely to file an involuntary bankruptcy petition.

As for debtor incentives, most debtors do not have the bargaining leverage to deny collateral to the secured party.<sup>70</sup> If the debtor wants new money to solve a liquidity crisis, it signs the lender's form and worries about the consequences later. The exception arises in industries where the volume of unsecured credit the market extends far outweighs the credit that the secured party will extend. For example, in the retail clothing store, drug store, or grocery store businesses, most inventory is lien free. The volume of unsecured trade credit is enormous in comparison to what a secured creditor will advance. Moreover, in these businesses, the debtor's payables often are factored by its vendors.<sup>71</sup> The factors will refuse to take the vendor's receivables if a lien is placed on the debtor's assets. In turn, this will result in an evaporation of trade credit for the debtor. The debtor would face an enormous liquidity crisis and would turn to its secured lender for more credit. Based on the level of cash required, the secured creditor would prefer that the trade creditors finance the debtor. Therefore, the debtor's secured lender will not encumber the debtor's inventory because it is in its own economic interest not to do so.

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<sup>69</sup> See, e.g., *Case v. Los Angeles Lumber Prods., Co.*, 308 U.S. 106 (1939); *Kansas City S. Ry. Co. v. Guardian Trust Co.*, 240 U.S. 166 (1916); *Northern Pac. Ry. Co. v. Boyd*, 228 U.S. 482 (1913). See generally 7 COLLIER ON BANKRUPTCY 1129-185 to -198 (Lawrence P. King ed., 15th ed. 1996) (discussing *Boyd* and *Case*).

<sup>70</sup> See, e.g., Vern Countryman, *Code Security Interests in Bankruptcy*, 75 COM. L.J. 269, 269 (1970) ("[Many practitioners and bankruptcy referees] report that . . . more and more bankruptcy cases emerge with every scrap of the bankrupt's property covered by some sort of a Code security interest. . . . That means, of course, that nothing will be distributed to any unsecured creditor, with or without priority."); Lynn M. LoPucki, *The Unsecured Creditor's Bargain*, 80 VA. L. REV. 1887, 1932 (1994) ("Except among the largest firms, it is a rare debtor that, at the time of liquidation, has assets not encumbered beyond their liquidation value.").

<sup>71</sup> "Factors" provide inventory financing to sellers of goods (usually without nonpayment recourse against the sellers) by advancing purchase money directly to manufacturers of those goods and taking a security interest in the sellers' accounts receivable. Advance rates are based upon a fixed percentage of those receivables. See generally JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE § 21-8, at 746-47 (4th ed. 1995) (explaining "factors"); Edward S. Adams et al., *A Revised Filing System: Recommendations and Innovations*, 79 MINN. L. REV. 877, 886-87 (1995) (describing "factors" in the textile industry).

## CONCLUSION

The broad-based critiques of the Proposal are largely without merit. The American Law Institute and the National Conference of Commissioners on Uniform State Laws should adopt the Proposal if they continue to proceed with efforts to expand the scope of Article 9 of the Uniform Commercial Code. Conceivably, it is asking too much of organizations whose drafting committees are dominated by attorneys who regularly represent secured creditors and academics who teach commercial law, to recommend a balanced approach with respect to secured credit. On the other hand, unless the Proposal, or something like it, is adopted, there is a remote possibility that Congress might exercise its prerogative under the Commerce Clause<sup>72</sup> and the Supremacy Clause<sup>73</sup> to federalize the laws of commercial transactions. Perhaps as we move toward the twenty-first century, it is time for Congress to do so.

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<sup>72</sup> See *supra* notes 48-50 and accompanying text.

<sup>73</sup> Article VI of the Constitution provides that "[t]his Constitution, and the Laws of the United States . . . shall be the supreme Law of the Land." U.S. CONST. art. VI, cl. 2.