Use of Collateral in Business Rehabilitations: A Suggested Redrafting of Section 7-203 of the Bankruptcy Reform Act

Patrick A. Murphy

Follow this and additional works at: https://scholarship.law.berkeley.edu/californialawreview

Recommended Citation
Patrick A. Murphy, Use of Collateral in Business Rehabilitations: A Suggested Redrafting of Section 7-203 of the Bankruptcy Reform Act, 63 Calif. L. Rev. 1483 (1975).

Link to publisher version (DOI)
https://doi.org/10.15779/Z38K16R

This Article is brought to you for free and open access by the California Law Review at Berkeley Law Scholarship Repository. It has been accepted for inclusion in California Law Review by an authorized administrator of Berkeley Law Scholarship Repository. For more information, please contact jcera@law.berkeley.edu.
Use of Collateral in Business
Rehabilitations: A Suggested Redrafting
Of Section 7-203 of the Bankruptcy Reform Act

Patrick A. Murphy†

This Article discusses problems regarding the treatment of secured creditors that have arisen under the rehabilitative Chapters of the current Bankruptcy Act. The author suggests changes in the Proposed Act which would deal with these problems and alleviate drafting ambiguities to clarify the rights of debtors and secured creditors in bankruptcy rehabilitations.

I
INTRODUCTION

One of the most difficult tasks involved in drafting bankruptcy legislation is balancing the need to rehabilitate debtors against the need both to preserve the integrity of previous transactions between the debtor and his creditors and to determine the extent to which creditors should be forced to surrender their rights to assist the debtor in the process of rehabilitation.

When considering a debtor’s original application for business credit, the creditor’s acceptance of the application and determination of the interest charged for the loan are based upon two main factors: (1) the monetary return to the creditor for the use of its funds or property; and (2) the creditor’s assessment of the risk that the debtor’s obligations will not be discharged as agreed upon. Where the risk of nonpayment appears to be great, the creditor can compensate, either by charging a greater rate of interest on the loan (in effect a form of self-insurance against loss) or by obtaining support for the loan in the form of a guaranty or additional collateral, such as by taking a lien upon the property acquired with the proceeds of the loan.

† A.B. 1961, Williams College; LL.B. 1965, Boalt Hall School of Law, University of California, Berkeley; Partner in the law firm of Cowans & Murphy, San Francisco; member of the National Bankruptcy Conference. The author is also a member of the American Bankers Association Task Force on Bankruptcy.
One of the express reasons for the enactment of the Uniform Commercial Code was the need to facilitate secured financing transactions "with less cost and greater certainty." While there is opinion that the ease and simplicity with which a security interest may be obtained and perfected under the Uniform Commercial Code has swung the pendulum too far in the direction of secured creditors, it can scarcely be argued that the prior state of affairs, a confusing amalgam of varying, expensive and often ineffective state laws, was in any way preferable. It is in the public interest that secured financing be available to business debtors on an inexpensive and reasonably certain basis. It follows that the bankruptcy process should not be permitted to interfere with creditors' security interests in the property of debtors to an extent which would erode the confidence of the credit industry in the integrity of secured transactions.

From time to time it is argued that substantial erosion of the rights of secured creditors is justified as being in the public interest. The argument is invariably made in well-publicized cases, where the failure of the debtor would cause widespread hardship to the public. However, there are several reasons why this "public interest" analysis is not compelling. First, although the continued operation of a large debtor at the expense of its creditors may protect some interests, it may also cause hardship to certain other broad segments of the public, such as bondholders. Second, it is not clear why the rehabilitation of large debtors should be more in the public interest than the rehabilitation of the more numerous smaller debtors. Third, if rehabilitation at the expense of creditors is in the public interest, it is reasonable to suggest that the public should pay for it by taxation. Similar arguments can be made with respect to the rights of unsecured creditors who have an interest in the general estate of the debtor. Indeed, it is debatable whether the secured creditor's rights in specific property are greater than an unsecured creditor's general interest in all of the debtor's unencumbered assets.

4. Substantial litigation in railroad reorganization cases is brought by classes of bondholders. In the New Haven Inclusion Cases, 399 U.S. 392, 491-92 (1970) the Supreme Court suggested that by purchasing the securities of a railroad, the bondholders had "assumed the risk" that their interests might be affected by the public interest. Id. at 492.
5. U.S. CONST. amend. V; see Murphy, Restraint and Reimbursement: The Secured Creditor in Reorganization and Arrangement Proceedings, 30 Bus. LAW. 15, 16, 33, 45 (1974) [hereinafter cited as Murphy].
The Commission on the Bankruptcy Laws of the United States has proposed sweeping revisions of the present bankruptcy law, including that portion of the law dealing with secured creditors. Similar legislation has been suggested by the National Conference of Bankruptcy Judges. While the two bills differ in a number of important respects, the sections dealing with the use of collateral in rehabilitative proceedings are quite similar. This Article will examine section 7-203 of the


7. H.R. 31, 94th Cong., 1st Sess. (1975) [hereinafter cited as the Proposed Act]. In particular, see Proposed Act §§ 2-201, 4-501, and 7-203.

The language of the Proposed Act is virtually the same as that set forth in Part II of the REPORT, supra note 6.


9. The relevant sections are section 7-203 of the Proposed Act and section 4-715 of the Judges’ Bill. The Proposed Act provides:

(a) Use of Property. Notwithstanding the terms of a lease of personal property or a security agreement,

(1) the trustee, receiver, or the debtor when no trustee or receiver is appointed, may use property of the estate subject to a lien, and the proceeds thereof, and personal property leased pursuant to a lease that has not been assumed, in the operation of the business of the debtor, until termination of the stay prescribed by section 4-501; and

(2) property acquired by the trustee or the debtor after the date of the petition shall not be subject to any lien resulting from a security agreement entered into by the debtor prior to the date of the petition.

(b) Relief from or modification of stay. Pursuant to the Rules of Bankruptcy Procedure and section 4-501(c), a secured party or lessor may file a complaint (1) to terminate the stay, or (2) to modify the stay by imposing such conditions on the use of the property or the proceeds thereof as will adequately protect the secured party. The trustee or debtor shall have the burden of proving that the value of the secured creditor’s interest in the property or the property leased as of the date of the petition is adequately protected.

Proposed Act, supra note 7, § 7-203.

The Judges’ Bill provides:

(a) Use of Property.—Notwithstanding the terms of a lease of property or a security agreement, the trustee, or the debtor when no trustee is appointed, may, until termination of the stay prescribed by section 4-501, use—

(1) rents and profits of real estate owned or held under lease by the debtor;

(2) property leased pursuant to a lease that has not been assumed; and

(3) property of the estate subject to a lien, other than the proceeds of collateral, and may continue to use the proceeds of collateral upon the filing of an involuntary petition or upon the filing of a voluntary petition, if notice of the filing of the petition is served upon the secured party or parties by any form of mail requiring a signed receipt concurrently with the filing of the petition.

(b) After-Acquired Property.—Property acquired by the trustee or the debtor after the date of the petition shall not be subject to any lien resulting from a security agreement entered into by the debtor prior to the date of the petition.

(c) Relief from or Modification of Stay.—Pursuant to the Rules of Bankruptcy Procedure and section 4-501(c), a secured party or lessor may file a complaint (1) to terminate the stay, or (2) to modify the stay by imposing such conditions on the use of the property or the proceeds thereof as will ade-
Proposed Act, and will refer to section 4-715 of the Judges' Bill only where it materially differs from the Proposed Act.

The two bills contain much that is new and controversial, and each would materially alter the existing law with respect to business rehabilitation. Both bills break precedent by dealing with the question of the use of collateral in express statutory provisions. In addition, the three Chapters of the Bankruptcy Act that apply to business rehabilitations, Chapters X, XI and XII, have been combined in the Proposed Act into one Chapter intended to include the positive elements of its three predecessors. The most significant debate respecting this change is whether this combination of elements into one Chapter will destroy the flexibility inherent in Chapter XI, by far the most popular rehabilitative chapter of the Bankruptcy Act. With a number of adjustments, however, Chapter VII of the Proposed Act should retain most of the flexibility of the present Chapter XI while incorporating desirable aspects of Chapters X and XII, such as the ability to alter or modify the rights of secured creditors and shareholders.

II

POWER OF THE BANKRUPTCY COURT TO DEAL WITH SECURED CREDITORS

Existing law concerning the treatment of secured creditors in Chapter proceedings is based on a combination of statutory and case
authority. The problem of secured creditors under each of the rehabilita-
tion Chapters breaks down into two parts: (1) is there jurisdiction over
the asset in question; and (2) if so, what are the powers of the court
with respect to the continued use of that asset by trustee, receiver or
debtor?15

A. The Ground Rules

In Chapter X corporate reorganizations, the jurisdiction of the
court extends to all property of the debtor wherever located, including
assets in the hands of pledgees and assets in the possession of state court
receivers or trustees appointed in lien foreclosure actions.20 In the
exercise of its jurisdiction, the court may stay creditor foreclosure ac-
tions,21 order a turnover of property to the reorganization trustee for use
in the rehabilitative proceeding,22 and ultimately order the alteration or
modification of a secured creditor's rights in the plan of reorganization,
even denying that creditor a vote if the court finds that its rights have
been adequately protected.23 Clearly, this is strong medicine and ac-
counts for the view shared by some members of the credit industry that
bankruptcy proceedings are stacked in favor of debtors and trustees.
While this belief is largely unwarranted, secured creditors enjoying
almost excessive deference in most cases, some extreme decisions sup-
port those who believe creditors are treated unfairly.24 It is no secret that
a substantial amount of lawyer time is spent trying to make major
secured transactions "bankruptcy proof," not just in the sense of defend-
ing a possible attack under the voiding powers,25 but also in the sense of
defeating the jurisdiction of the court in rehabilitative proceedings.

18. The jurisdiction provisions are sections 111 and 256 of Chapter X (11 U.S.C.
§§ 511, 656 (1970)), section 511 of Chapter XI (11 U.S.C. § 711 (1970)), and sec-
tions 411 and 506 of Chapter XII (11 U.S.C. §§ 811, 906 (1970)).
19. With respect to the powers of the Chapter X and XI courts, see Festersen,
Equitable Powers in Bankruptcy Rehabilitation: Protection of the Debtor and the
Doomday Principle, 5 CREIGHTON L. REV. 221 (1972); Murphy, supra note 5.
It is probable that section 257 (11 U.S.C. § 657) includes personal and real property
lien foreclosure trustees, as well as mortgagees and trustees in possession in non-judicial
foreclosure actions. 6A W. COLLIER, BANKRUPTCY ¶ 14.03, at 1106 n.48a (14th ed.
1972).
See Murphy, supra note 5, at 29-30.
22. Reconstruction Finance Corp. v. Kaplan, 185 F.2d 791 (1st Cir. 1950); 6 W.
COLLIER, BANKRUPTCY ¶ 3.05, at 438 n.23 (14th ed. 1972).
commonly referred to as the "cram down" provision of Chapter X.
24. Two examples of extreme treatment of secured creditors are In re Yale Ex-
press System, Inc., 384 F.2d 990 (2d Cir. 1967), and Wachovia Bank & Trust Co. v.
Harris, 455 F.2d 841 (4th Cir. 1972). See text accompanying notes 69-71 and 141
infra.
25. The basic voiding powers in the Bankruptcy Act are found in sections 60
Chapter XII, which was enacted in an effort to meet the demands of a special situation, has been used only sporadically. In the last few years it has increased in popularity, however, particularly among real estate-oriented partnerships with severe secured creditor problems. Chapter XII combines features of both Chapter X and Chapter XI and is available only to non-corporate individuals and partnerships to whom Chapter X is unavailable. It is substantively akin to Chapter X, particularly in the provisions dealing with secured creditors. Under Chapter XII, jurisdiction of the court extends to assets of the debtor without regard to location. Where the collateral is real estate, a receiver or trustee appointed in a different judicial action can be displaced and a secured creditor in possession can be forced to surrender the property. As is the case in Chapter X, the rights of a secured creditor may be altered or modified in the Chapter XII plan without its consent if the court finds that the rights of the creditor are adequately protected.

Chapter XI, which had different origins from Chapter X, is a composition or extension statute available to any business debtor and has less impact on the secured creditor. The recent view is that the jurisdiction of the Chapter XI court extends to assets of the debtor whether or not they are in the hands of creditors, and, consequently, that bankruptcy courts have the power to stay foreclosure actions without regard to custody.

(dealing with preferences), 67a (dealing with involuntary liens), 67c (dealing with statutory liens), 70c (giving the trustee the rights and powers of a lien creditor under state law), and 70e (dealing with transfers voidable by an actual creditor). 11 U.S.C. §§ 96a, 107a, 107c, 110c, and 110e (1970). The voiding powers of an ordinary bankruptcy trustee are generally available to the debtor, receiver or trustee in a rehabilitative proceeding. In re Martin Custom Made Tires Corp., 108 F.2d 172 (2d Cir. 1939).

31. Compare Report, supra note 6, Part I at 240, with id. at 241-44.
er the court has the power to require the turnover of collateral in the possession of a secured creditor. There is no power to alter or modify the rights of the secured creditor in the Chapter XI plan of arrangement and, despite the language of section 372, there is no power to continue a stay of foreclosure past the final decree. For a debtor with secured creditor problems, Chapter XI offers time but does not offer an ultimate solution; either differences with secured creditors must be compromised or the secured obligation must be paid or refinanced prior to entry of the final decree.

In ordinary bankruptcy proceedings (as opposed to Chapter proceedings) under existing law, the ability to deal with secured creditors is very limited since the jurisdiction of the court extends only to collateral in the possession of the bankrupt at the time of filing. This limited jurisdiction and the accepted view that a Chapter proceeding is improper if a liquidation is inevitable from the outset, have made it almost impossible to control secured creditor actions in bankruptcy liquidations.

One of the many deficiencies of the existing bankruptcy law is the fact that commercial law, in particular Article 9 of the Uniform Commercial Code, has outgrown the Bankruptcy Act. For example, the language of Chapter XI, which is based on the concept that the rights of secured creditors may not be altered or modified, does not meet the needs of a debtor whose assets are totally encumbered by a floating lien. If the debtor's existing and future inventory and accounts are subject to a security interest, the debtor cannot receive any relief under the Bankruptcy Act unless the rights of the secured creditor are altered at the outset of the proceeding—something that can never be done under Chapter XI. The need for bankruptcy legislation that more nearly fits current commercial law is almost beyond dispute.

B. Landmark Decisions

A review of significant case law developments is vital to understanding the problems that must be met in preparing new legislation. While many cases involving secured creditors have been decided under the Bankruptcy Act, it is easy to recognize the landmark cases. The most

35. This question must be answered in the negative if another judicial officer has taken possession of the asset. In re Victor Builders, Inc., 418 F.2d 880, 882 (9th Cir. 1969).
37. 2 W. COLLIER, BANKRUPTCY ¶ 23.05 (14th ed. 1975).
38. Fidelity Assurance Ass'n v. Sims, 318 U.S. 608 (1943); 8 W. COLLIER, BANKRUPTCY ¶ 3.16[3], at 222 (14th ed. 1975).
39. UNIFORM COMMERCIAL CODE §§ 9-108 and 9-204(1).
significant law concerning the treatment of secured creditors in bankruptcy proceedings has been developed in decisions that have had only indirect support in the existing legislation and that have had to rely, therefore, upon the implied equitable powers of the bankruptcy court. While statutory law describes the scope of bankruptcy court jurisdiction, the proper exercise of that jurisdiction has been left to the discretion of the judge, particularly where the use of collateral is at issue.

A very early case dealing with control of foreclosure actions by secured creditors was *Ex parte Christy.* The national bankruptcy legislation in force at the time the case was decided did not explicitly deal with secured creditors. But the United States Supreme Court held that the bankruptcy court had the power to control foreclosure actions by creditors. The Court explained the lack of explicit statutory authority as follows:

> From this brief review of these enactments it is manifest that the purposes so essential to the just operation of the bankrupt [sic] system, could scarcely be accomplished; except by clothing the courts of the United States sitting in bankruptcy with the most ample powers and jurisdiction to accomplish them; and it would be a matter of extreme surprise if, when Congress had thus required the end, they should at the same time have withheld the means by which alone it could be successfully reached.

The result has remained one of the fundamentals of bankruptcy law: the bankruptcy court, as a court of equity exercising *in rem* jurisdiction over assets in its custody and control, can protect its jurisdiction by injunction.

The most significant decision of the Supreme Court concerning the jurisdiction and power of a federal court, sitting as a court of bankruptcy, over assets in the physical possession of a secured creditor was *Continental Illinois National Bank & Trust Co. v. Chicago Rock Island & Pacific Railway.* The legislation in effect at the time the case

---

40. 44 U.S. (3 How.) 292 (1845).
41. That legislation read in part as follows:

> [T]he jurisdiction hereby conferred on the district court shall extend to all cases and controversies in bankruptcy arising between the bankrupt and any creditor or creditors who shall claim any debt or demand under the bankruptcy

Act of August 19, 1841, ch. 9, § 6, 5 Stat. 445 (repealed by Act of March 3, 1843, ch. 82, 5 Stat. 614). The Supreme Court had no doubt that this provision was intended to apply to secured as well as unsecured creditors. *Ex parte Christy,* 44 U.S. (3 How.) 292, 315-22 (1845).

42. 44 U.S. (3 How.) 292, 312 (1845).
43. Subsequently, the Court held that the power of the bankruptcy court did not extend to a negotiable instrument in the hands of a pledgee. *Jerome v. McCarter,* 94 U.S. 734, 739 (1876).
44. 294 U.S. 648 (1935).
was decided, section 77—providing for the reorganization of railroads—expressly dealt only with the stay of judicial proceedings to enforce liens, but the Court held that the bankruptcy court had the power to stay the foreclosure sale of pledged collateral under its inherent powers as a court of equity, under the "all writs" statute, and under section 2(15) of the Bankruptcy Act. Although it was a section 77 case, Rock Island was applied in section 77B corporate reorganization proceedings, and subsequently has been applied under the current Bankruptcy Act in proceedings under Chapter XI and to some extent Chapter XII. Generally stated, Rock Island stands for the propositions that, first, the jurisdiction of the bankruptcy court extends to secured creditors in possession and, second, the impairment of the secured creditor's foreclosure remedy is not an unconstitutional taking.

In another significant decision, Wright v. Union Central Life Insurance Co., the Court held that the appraisal provision of the Frazier-Lemke Act, in addition to being constitutional, was mandatory, and that the rights of the secured creditor had been adequately protected: "Safeguards were provided to protect the rights of secured creditors, throughout the proceedings, to the extent of the value of the property . . . there is no constitutional claim of the creditor to more than that." Of all the language in cases considering the constitutional rights of secured creditors, this statement is probably the clearest. According to Wright, the secured creditor has a distinct property interest entitled to constitutional protection throughout the proceeding, but that property interest is limited to the value of the collateral and should be distinguished from the secured creditor's procedural remedies, which can be impaired or even abrogated.

45. Id. at 675-76.
46. In re Prudence-Bonds Corp., 77 F.2d 328 (2d Cir. 1935).
47. In re United States Realty & Improvement Co., 153 F.2d 853 (2d Cir. 1946);
50. Act of Aug. 28, 1935, ch. 792, 49 Stat. 942. The Frazier-Lemke Act was designed to provide relief to the nation's farmers. The section dealing with appraisal provided that the debtor could free his land of encumbrances by paying into the court the appraised value of the land. The appraisal thus fixed the payment the debtor was required to make in order to obtain clear title, and the payment was to be distributed to creditors. Id. at § 6(a)(3).
51. 311 U.S. 273, 278 (1940).
52. Continental Illinois Nat'l Bank & Trust Co. v. Chicago Rock Island & Pac. Ry., 294 U.S. 648 (1935) said in this regard: "The injunction here in no way impairs the lien, or disturbs the preferred rank of the pledgees. It does no more than suspend the enforcement of the lien by a sale of the collateral pending further action." Id. at 676-77. See also, Kuehner v. Irving Trust Co., 299 U.S. 445, 452 (1937).
By the end of the 1930's, two important issues relating to the use of a secured creditor's collateral remained to be decided. The first involved the court's power to force the surrender of collateral possessed by the secured creditor for use in the rehabilitative proceeding. The second question was whether such use would be permitted where the collateral would be totally or partially consumed in the process.

Although the Supreme Court has yet to discuss either issue, analysis of a series of decisions at the circuit court level provides a growing body of case law on both points. It is now accepted that the Chapter X court has the power to displace secured creditors in possession of the debtor's assets at the time of filing. The authorities for this proposition are section 257 of Chapter X and, perhaps more appropriately, the general powers of a court of equity. It can be assumed that similar powers exist in Chapter XII, at least where the collateral is real estate. In Chapter X proceedings in which the collateral is real estate, a number of decisions have considered the basis for the ouster of the secured creditor or his representative.

Foremost among the few decisions involving personal property is Reconstruction Finance Corp. v. Kaplan, where the court assumed without discussion that its powers under section 257 extended to personal property. The fact situation in Kaplan resembles contemporary situations under the Uniform Commercial Code in that the Reconstruction Finance Corporation held a lien on virtually every asset of the debtor, the Waltham Watch Company. Prior to Waltham's filing of the Chapter X petition, the Reconstruction Finance Corporation had taken possession of the debtor's assets and was left in possession for the first few

53. 6 W. Collier, Bankruptcy ¶ 3.05 (14th ed. 1972).
55. Significant ouster cases include In re Georgetown on the Delaware, Inc., 466 F.2d 80 (3d Cir. 1972) and In re Franklin Garden Apartments, 124 F.2d 451 (2d Cir. 1941). At present it is unclear whether the question of material harm to the secured creditor is to be considered at the hearing on the turnover order or whether such a determination can be postponed to a later date. Compare In re Colonial Realty Investment Co., 516 F.2d 154 (1st Cir. 1975), with In re Riker Delaware Corp., 385 F.2d 124 (3d Cir. 1967).
56. Cf. In re Moulding-Brownell Corp., 101 F.2d 664 (7th Cir. 1939), where the court ordered the surrender of accounts receivable proceeds to the trustee. The limited sums involved and the requirement that the proceeds be impounded by the trustee make Moulding-Brownell doubtful authority for the proposition that the trustee in Chapter X can force the surrender of personal property for use in the business. Section 257 of Chapter X, 11 U.S.C. § 657 (1970), provides statutory authority for such power in the case of real property although it is uncertain from its wording that it applies to personal property. See note 20 supra.
57. 185 F.2d 791 (1st Cir. 1950).
months of the proceeding. The trustees filed a plan within a few months (record time under Chapter X, where a period of several years often passes without a plan being filed) and asked that the Reconstruction Finance Corporation be ousted and that the trustees be permitted to complete and sell the substantial inventory that was on hand. Not only was this request granted by the court, but the trustees were also permitted to make use of cash that was being held by the Reconstruction Finance Corporation in a cash collateral account. It should be noted that the facts in the case were extremely favorable to the trustees in that the value of the collateral substantially exceeded the debt secured. The trustees also benefited by the fact that with the expenditure of approximately $260,000, the value of the collateral would have been increased by approximately $500,000.

It has been suggested that if there is a "leading" case concerning the power of the Chapter X court to force secured creditors to turn over collateral in their possession to the reorganization trustee, it is In re Third Avenue Transit Corp. From the perspective of the trustees, the facts were almost as bad in Third Avenue as they were good in Kaplan. Various properties subject to a mortgage securing outstanding bonds had been sold before and after the filing of the petition, and the proceeds had been delivered to the indenture trustee for the bondholders. The reorganization trustees then sought an order permitting them to use the funds as additional working capital. The district court judge granted the trustees' request upon the condition that the trustees issue to the bondholders a certificate of indebtedness bearing annual interest at a rate of 1.75 percent with an indefinite maturity date. This order was reversed on appeal on the ground that the district court had not made the following determinations: (1) that the funds were needed and could not be obtained through ordinary borrowing channels; (2) that there was a high degree of likelihood that the debtor could be reorganized; and (3) that the secured creditors would not be injured.

---

58. Id. at 792.
59. Id. at 793. It appears that the hearing on the plan and the hearing on the trustees' application were conducted on the same day and that the court's favorable decision on the plan may have influenced its decision on the trustees' application.
60. Id. at 798.
61. Id. at 793.
63. 198 F.2d 703 (2d Cir. 1952).
64. Id. at 705.
65. Note that the normal standard applied by the Chapter X court under section 146(3) in determining whether the petition has been filed in good faith is whether a "reasonable possibility" of reorganization exists. Grubbs v. Petit, 282 F.2d 557, 562 (2d Cir. 1960).
66. 198 F.2d at 706-07.
Avenue test has been applied frequently, although its relative severity has led courts to consider other approaches. 67

For reasons that were not entirely clear, the Third Avenue court applied section 257 of the Bankruptcy Act rather than section 116(2) and said that "the court's far more drastic power" under the former section "requires proof of the most extraordinary circumstances." 68 It is difficult to understand why the test of harm to the secured creditor should be given a materially different meaning on the basis of whether the cause of harm is the creation of a lien ahead of the existing liens under section 116(2), the entry or continuation of a stay under sections 116(4) or 148, or the requirement that collateral be turned over under section 257. An improvident exercise of judicial discretion can cause substantial loss in each instance. The judicial confusion on this point, as reflected in Third Avenue, is additional evidence that a reworking of the statutory language in the Bankruptcy Act with respect to the treatment of secured creditors is appropriate.

Two recent Chapter X decisions in the Second Circuit cast doubt on the continued viability of Third Avenue. Both cases dealt with the question of restraint in circumstances where the collateral was deprecating and the creditor was marginally secured. The first was In re Yale Express System, Inc., 69 undoubtedly the most liberal application of the power of the court to permit the continued use of collateral where loss to the secured creditor was a near certainty. The justification given by the court was that if one secured creditor was to be given any form of protection, then all would have to be treated equally 70—a dubious proposition at best. The court reasoned that the secured creditor could be compensated with a priority claim at the time of confirmation, which presumes that there will in fact be a confirmation. 71 The second decision to raise the question of depreciating collateral was In re Bermec Corp. 72 However, in that case the reorganization trustee offered to make interim payments to the secured creditors to protect them against depreciation. 73 Bermec is significant for establishing the concept of interim

68. 198 F.2d at 706.
69. 370 F.2d 433 (2d Cir. 1966) and 384 F.2d 990 (2d Cir. 1967).
70. 384 F.2d 990, 992.
71. A plan was confirmed in Yale Express, but this is by no means a certainty in Chapter X proceedings.
72. 445 F.2d 367 (2d Cir. 1971).
73. Bermec did not require the making of interim payments but did approve the concept. Id. at 369.
compensation as a means of avoiding harm to the secured creditor and for supporting the implication that absent such compensation, foreclosure might be permitted.\(^7\)

In short, analysis of the statutory and case law reveals there are substantial and perhaps unjustified variances between the three existing business rehabilitation Chapters of the Bankruptcy Act concerning the powers of the bankruptcy court with respect to secured creditors. Moreover, there is judicial confusion concerning the tests to be applied in exercising those powers. Section 7-203 of the Proposed Act represents the Commission's attempt to address these problems.

III

SUGGESTED REVISION OF SECTION 7-203

Section 7-203 of the Proposed Act provides in full:

Section 7-203. Use of Property Leased or Subject to a Lien.

(a) Use of Property. Notwithstanding the terms of a lease of personal property or a security agreement,

(1) the trustee, receiver, or the debtor when no trustee or receiver is appointed, may use property of the estate subject to a lien, and the proceeds thereof, and personal property leased pursuant to a lease that has not been assumed, in the operation of the business of the debtor, until termination of the stay prescribed by section 4-501; and

(2) property acquired by the trustee or the debtor after the date of the petition shall not be subject to any lien resulting from a security agreement entered into by the debtor prior to the date of the petition.

(b) Relief from or Modification of Stay. Pursuant to the Rules of Bankruptcy Procedure and section 4-501(c), a secured party or lessor may file a complaint (1) to terminate the stay, or (2) to modify the stay by imposing such conditions on the use of the property or the proceeds thereof as will adequately protect the secured party. The trustee or debtor shall have the burden of proving that the value of the secured creditor's interest in the property or the property leased as of the date of the petition is adequately protected.

A detailed analysis of the section will reveal its weaknesses and will suggest substantive revisions designed to improve upon the section's likely effects.

A. Notwithstanding the terms of a lease of personal property or a security agreement, . . .

The initial reaction to the opening lines of section 7-203 is that the Commission has given the debtor less than full relief. Conspicuously

\(^7\) Id.
absent are references to real property mortgages and lessors. While the Commission may have intended to include creditors holding obligations secured by a lien upon real estate, the term "security agreement" is not defined in the Proposed Act.\textsuperscript{76} Under the major piece of commercial legislation, the Uniform Commercial Code "security agreement" is a term of art\textsuperscript{76} which, to many lawyers, refers only to an agreement granting a secured creditor an interest in personal property. By its terms, section 7-203 deals with personal property leases, but, by implication, real property leases are excluded. If this is the correct interpretation of the section, a peculiar result ensues. Under a personal property lease, the receiver, trustee or debtor can use the asset without assuming the lease\textsuperscript{77} and without paying the scheduled rent on a current basis.\textsuperscript{78} By contrast, in the case of real property, section 4-602(b) of the Proposed Act appears to require assumption of the lease by the receiver, debtor or trustee and the making of scheduled rent payments as a condition to continued use.\textsuperscript{79} The omission of real property lessors from the preamble to section 7-203 of the Proposed Act is a mistake\textsuperscript{80} that should be rectified as it was in section 4-715 of the Judges' Bill. The purpose of Chapter VII is the rehabilitation of business debtors, and it can scarcely be disputed that the debtor's relations with its real property lessors will affect its prospects for rehabilitation. The apparent requirement that the real property lessor be paid on a current basis may be too great a burden for the debtor to bear.

It is suggested that the preamble to section 7-203(a) be amended to read:

Notwithstanding the terms of any agreement between the debtor and a secured party or lessor . . . .

\textsuperscript{75} Definitions are set forth in section 1-102 of the Proposed Act, supra note 7, and section 1-102 of the Judges' Bill, supra note 8.

\textsuperscript{76} See Uniform Commercial Code § 9-105(1).

\textsuperscript{77} Under the current Bankruptcy Act it is often undesirable to assume a lease at the early stages of a Chapter XI proceeding because a later breach by the receiver, trustee or debtor would give rise to a substantial "expense of administration" claim. Bankruptcy Act §§ 64(1), 337, 11 U.S.C. §§ 104, 737 (1970). See 3A W. Collier, Bankruptcy ¶ 64.105; 8 W. Collier, Bankruptcy ¶ 5.33[3.1] at 670 (14th ed. 1975).

\textsuperscript{78} Proposed Act, supra note 7, at § 7-203(a)(2).

\textsuperscript{79} Id. § 4-602(b).

\textsuperscript{80} There has been much litigation with respect to "ipso facto" clauses in leases of real estate, so called because the bankruptcy termination clause in the lease takes effect without any action by the lessor. The landmark case was Finn v. Meighan, 325 U.S. 300 (1945). The issue in recent case law has become very similar to the problem of secured creditors. See, e.g., In re D.H. Overmeyer Co., Inc., 510 F.2d 329 (2d Cir. 1975); Queens Blvd. Wine & Liquor Corp. v. Blum, 503 F.2d 202 (2d Cir. 1974). Dictum has suggested that, notwithstanding Finn v. Meighan, termination will not be permitted where there are "overriding equitable considerations". In re D.H. Overmeyer Co., supra at 333.
This amendment would preclude any argument that the real property lessor is entitled to a higher order of rights than personal property lessors and secured creditors. The revision would also eliminate use of the undefined and potentially confusing term “security agreement.”

B. The trustee, receiver, or the debtor where no receiver or trustee is appointed, may use the property of the estate subject to a lien, and the proceeds thereof, and personal property leased pursuant to a lease that has not been assumed, in the operation of the business of the debtor, until termination of the stay prescribed by Section 4-501 . . . .

Section 7-203 does not deal with the jurisdiction of the court over the property in question. A major area of uncertainty under the present Bankruptcy Act concerns whether the Chapter X, XI or XII court has jurisdiction over property in the physical possession of the secured creditor at the time of filing. Two questions are presented: (1) does the court have the power to stay the secured creditor from commencing or continuing a foreclosure action; and (2) does the court have the power to order a secured creditor in possession to surrender the property for use in the rehabilitative process? Section 7-203 of the Proposed Act contemplates the use of collateral but fails to deal with the initial question of obtaining the property from a secured creditor in possession. Section 2-201 of the Proposed Act is clearly intended to extend the jurisdiction of the court to property of the estate wherever located and, when read with section 4-501, would permit the court to stay a secured creditor in possession even in a straight bankruptcy proceeding—clearly a change from existing law. However, neither the Proposed Act nor the Judges’ Bill deals expressly with the recovery of property from secured creditors in possession.

A possible source of confusion in the Proposed Act is section 4-603(a)(1), which provides for the ouster of state court receivers and trustees. This section is redundant in light of section 2-201’s all-encompassing jurisdiction, unless it is read simply as an attempt to clarify the point that any argument based on “comity” should not be available to defeat the jurisdiction of the bankruptcy court. Expanded jurisdiction

81. See text accompanying notes 20-22, 29 and 33 supra.
82. See text accompanying notes 22 and 35 supra.
84. Section 4-603(a)(3) of the Proposed Act, supra note 7, is intended to cover custodians and agents of secured creditors but is not broad enough to require the turnover of property by secured creditors who have personally taken possession of collateral. For example, usually the beneficiary, rather than the trustee, under a deed of trust takes possession of the property upon the trustor’s default.
under section 2-201, in combination with the broad definition of "property of the estate" under section 4-601, indicates that the Commission intended to give the court power to deal with collateral in the possession of secured creditors. This should be clarified, however, in the general part of the legislation, Chapter IV of the Proposed Act, rather than in Chapter VII, in order for the court to have comprehensive power in liquidation proceedings and in the rehabilitative chapters.

A major issue that has not been addressed by section 7-203 concerns the situation in which the debtor's interest in property is not a fee interest and may not be "property of the estate" as the term is defined in section 4-601(a). One example is the situation in which the debtor is a lessee, and the holder of a senior interest encumbering the fee threatens to foreclose, thereby wiping out the lease in the process. Another example is the situation in which the debtor's property is an obligation secured by a junior interest in property owned by a third party, and that obligation is in danger of becoming valueless due to the foreclosure of a superior interest. In each instance, if the bankruptcy court stayed the foreclosure proceeding, it would impair an obligation existing between third parties and thus produce the indirect effect of offering bankruptcy relief to the owner of the asset being foreclosed upon without the owner having submitted its assets to its creditors. The question is whether the relief afforded by section 4-501 of the Proposed Act should be limited to actions directed against "property of the estate," or whether an expanded form of jurisdiction should be recognized in the interests of rehabilitating worthy debtors where the threatened action would interfere with bankruptcy administration or materially damage "property of the estate." This is a difficult issue which should be dealt with under the stay provisions of section 4-501. While the bankruptcy court should have the power to protect its jurisdiction over the property of the estate, even against indirect threats, the property involved is that of a third party.

Section 7-203 authorizes the use of property, including leased assets. However, section 7-203 by itself does not expressly provide a stay, but rather guides the court as to when the section 4-501 stay should be vacated and what conditions should be placed on the use of the property by the receiver, trustee or debtor in a rehabilitative proceeding. Section 4-501, in turn, does not appear to cover leased assets since it applies only to "property of the estate," and it is questionable

---

86. Although there are no presently reported cases in point, the rapidly developing retreat from Finn v. Meighan, 325 U.S. 300 (1945), suggests that the void will soon be filled.

87. See, e.g., In re Westec Corp., 460 F.2d 1139 (5th Cir. 1972).

88. See text accompanying notes 40-43 supra.
whether a leased asset would be "property of the estate" as that term is defined in section 4-601. Therefore, under the present language of section 7-203, the power to stay personal property lessors may have to be extrapolated from section 7-203 or derived from the general equitable powers of the court. \(^9\) This problem cannot be resolved by redrafting section 7-203, since that section is not a stay provision. Section 4-501 is the only stay provision in the proposed legislation, and it was not drafted to meet the specific problems of the rehabilitative Chapter. Either there should be a separate stay provision for Chapter VII or section 4-501 should be substantially redrafted to cover rehabilitative proceedings as well as liquidations.

It should be noted that while the stay provision, section 4-501 applies in straight bankruptcies as well as in rehabilitative proceedings, \(^9\) section 7-203, governing the "use" of collateral, applies only in reorganization proceedings, and there is no comparable provision in straight bankruptcy under the Proposed Act. \(^1\) Most experienced insolvency specialists are familiar with situations where there is no hope of debtor rehabilitation but where completion of work in progress or completion of certain vital contracts may materially enhance the dividends available to creditors. In a straight bankruptcy proceeding, should a single secured creditor be able to force a cessation of operations at the expense of other interests, or should the enhancement of dividends be a sufficient ground in itself to permit the use of the collateral by the trustee? \(^2\) A possible solution to this problem would be to allow the debtor to proceed under Chapter VII long enough to complete work in progress, even though the prospects of rehabilitation are dim. Section 7-112 of the Proposed Act suggests the court may have more discretion in this regard than does a court under the current Bankruptcy Act. \(^3\)

Several commentators have criticized the failure of section 7-203(a)(1) to distinguish among the various types of collateral that may

---

\(^9\) In Bank of Marin v. England, 385 U.S. 99, 103 (1966), Mr. Justice Douglas said: "There is an overriding consideration that equitable principles govern the exercise of bankruptcy jurisdiction."

\(^1\) Section 4-501 is found in Proposed Act, supra note 7, Chapter IV, which, by its own terms, applies to proceedings under more than one chapter.

\(^2\) See Proposed Act, supra note 7, Chapter V.

\(^3\) The author has been advised of at least one unreported instance in the Southern District of New York where collateral was used in an ordinary bankruptcy proceeding over the objections of the secured creditor. Address by Professor Charles Seligson, ALI-ABA Course of Study, Business Reorganizations in Depth, February 18, 1971. The facts of Reconstruction Finance Corp. v. Kaplan, 185 F.2d 791 (1st Cir. 1950) exemplify a situation in which dividends might be materially enhanced by completing work in progress. See text accompanying notes 57-61 supra.

\(^3\) Compare text accompanying note 38 supra, with Proposed Act, supra note 7, § 7-112.
be used by the receiver, trustee or debtor.4 Continued use of real estate or a piece of heavy equipment will not under ordinary circumstances result in any substantial loss to the secured creditor from the time of commencement of the proceeding until the time when a complaint filed by the secured creditor under section 4-501(c) can be heard. However, this is not the case with “soft” collateral such as accounts and inventory. In some businesses the collection period for accounts is as short as a few days and a large dollar volume of accounts could be collected in the first few days after filing. If the debtor is allowed to use this collateral until the date of a section 4-501(c) hearing, the result could be a real and substantial loss to the secured creditor.

A possible solution to the soft collateral problem would be to require a prior hearing where the collateral is of the type that would rapidly dissipate, while permitting the receiver, debtor or trustee to make immediate or continued use of “hard” collateral such as equipment and real estate. The hearing would have to be early in the proceeding,5 even before the first meeting of creditors, which must be at least 20 days after filing,6 a period few businesses could survive without access to inventory and account collections. The hearing should occur 2 or 3 days after filing, and could be handled in a two stage process: first, an informal hearing similar to a hearing on a temporary restraining order,7 and then a more thorough hearing within 10 days thereafter. In order for the right to notice and hearing to be meaningful, judicial time will have to be made available by eliminating the current bankruptcy court calendar problems. It is common practice in many bankruptcy courts to take several months to hear a complaint to vacate a stay.

The analogy to the hearing on a temporary restraining order raises the question whether the court should be authorized to permit use on an ex parte basis. In almost every situation the secured creditor has become thoroughly alarmed prior to filing,8 and it seems reasonable to require the trustee, receiver or debtor to notify the creditor of the hearing sufficiently in advance to permit attendance.9 One of the differences between section 4-715 of the Judges’ Bill and section 7-203 of the

4. N.Y. City Bar Committee Report, supra note 16, at 45; Coogan, Broude & Glatt, supra note 14, at 1168-79.
8. Virtually the only exception that comes to mind is where the debtor has been actively deceiving the creditor as to the true state of the debtor's affairs.
Proposed Act is that the Judges' Bill would require the trustee, receiver or debtor to serve notice by mail of the filing of the petition upon the secured party as a condition to use of the proceeds of collateral. This protection is not likely to be adequate where the collateral is perishable, however, since even prompt action by the secured creditor may not prevent substantial loss. If the changes suggested in this Article are adopted, such notice would become irrelevant in the case of "soft" collateral but should be required in the case of "hard" collateral.

A suggested redrafting of section 7-203, distinguishing between "hard" and "soft" collateral, follows:

[T]he trustee, receiver or the debtor when no trustee or receiver is appointed, may use property of the estate subject to a lien, and the proceeds and products thereof, and property leased pursuant to a lease that has not been assumed, in the operation of the business of the debtor, until termination or modification of the stay prescribed by section 4-501, provided, however, that in the event of any such use of real property, chattels real, equipment or general intangibles subject to a lien or leased to the debtor, notice of the filing of the petition initiating the proceeding shall be served upon the secured party or lessor within five days of the filing of the petition by any form of mail requiring a signed receipt and that prior to any such use if inventory, accounts or chattel paper or the proceeds and products thereof subject to a lien or of the proceeds and products of any equipment or general intangibles subject to a lien, the trustee, receiver or debtor shall have obtained an appropriate court order, after hearing upon notice to the secured party and a showing of good cause, which court order shall contain provisions adequately protecting the secured party . . .

The two-step nature of the hearing (an informal hearing 2 or 3 days after filing, followed by a thorough hearing within 10 days) should be set forth in Rules of Bankruptcy Procedure. 100

C. Property acquired by the trustee or the debtor after the date of the petition shall not be subject to any lien resulting from a security agreement entered into by the debtor prior to the date of the petition.

This part of section 7-203 is confused by the language of the Note to the section. Ordinarily, under the Uniform Commercial Code, when one speaks of liens upon after-acquired property the relevant sections are assumed to be sections 9-108 and 9-204 of the Code, which relate to the "floating lien." However, the Note to section 7-203 of the Proposed Act indicates that this section is intended to limit the efficacy in Chapter VII cases of "after-acquired property clauses and the secured party's

100. See Proposed Act, supra note 7, § 2-204.
The right to proceeds under the Uniform Commercial Code is covered by section 9-306 of the Code and is a concept quite different from that of after-acquired property. If in fact the Note to section 7-203 of the Proposed Act reflects the intent of the Commission, then the target is the secured creditor's right to proceeds afforded by section 9-306 of the Uniform Commercial Code. Thus, the "use" of the collateral permitted by section 7-203, which almost certainly would result in transmutation of collateral into proceeds, would also result in a loss of the secured creditor's lien. This possibility has caused justified alarm in secured creditor circles.

It is appropriate that the secured creditor's "floating lien" on after-acquired property cease to float upon the commencement of a proceeding under Chapter VII. In the few instances under the existing Bankruptcy Act where a secured creditor has argued that its floating lien was effective after the filing of a Chapter XI petition, the courts have refused to agree, based on the theory that the Chapter XI debtor in possession is a different legal entity from the pre-bankruptcy debtor. The fresh start policy can be suggested as an alternative and equally persuasive argument against continuation of the floating lien after bankruptcy. To permit a lien or security interest to attach to property acquired by a debtor or bankrupt after filing would frustrate the purpose of a bankruptcy discharge.

There is no reason, however, why the secured creditor's rights to proceeds should not be respected in bankruptcy proceedings. Since, under the Proposed Act, the transfer of the debtor's property by operation of law to the trustee or debtor in possession presumably leaves existing collateral subject to the rights of the secured creditor, there is no reason why the new legal entity should not take the proceeds of existing collateral subject to the secured creditor's claim. The right to proceeds does not abrogate the fresh start policy, since proceeds are merely a substitution for pre-bankruptcy property sufficiently rooted in the pre-

---

101. Proposed Act, supra note 7, § 7-203, Note 4 (emphasis added).
102. Under the UNIFORM COMMERCIAL CODE, 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, and also continues in any identifiable proceeds including collections received by the debtor.

Id. § 9-306(2).
103. N.Y. CITY BAR COMMITTEE REPORT supra note 16, at 47; Coogan, Broude and Glatt, supra note 16, at 1177.
106. See Proposed Act, supra note 7, §§ 7-201, 4-604.
bankruptcy past. However, assuming the Commission's views prevail, if the secured creditor's rights in both after-acquired property and in proceeds are to be restricted, the court, in fashioning conditions for continued use of disposable collateral, should be required to fix the secured creditor's lien in substitute collateral regardless of whether there is compliance with Uniform Commercial Code section 9-306(3).

A redraft is suggested as follows:

Property acquired by the trustee or the debtor after the date of the petition shall not be subject to any lien resulting from an after-acquired property clause in any agreement entered into by the debtor prior to the date of the petition.

This amendment would make it clear that the rights of the secured creditor would continue in the proceeds of the collateral notwithstanding use of the collateral by the trustee, receiver or debtor.

D. Pursuant to the Rules of Bankruptcy Procedure and section 4-501(c) a secured party or lessor may file a complaint (1) to terminate the stay, or (2) to modify the stay by imposing such conditions on the use of the property or the proceeds thereof as will adequately protect the secured party.

The bankruptcy court has two duties under subpart (b) of section 7-203: upon the request of the creditor-lessee, the court is required to consider whether the stay should be terminated, and if it decides to continue the stay, the court must determine what conditions should be imposed upon the debtor as a price for its continuance. At the outset of most rehabilitative proceedings under the current Bankruptcy Act, the judge is under strong pressure not to terminate the stay if the rehabilitative process is likely to collapse, particularly where the debtor's immediate adjudication as a bankrupt would cause substantial loss to innocent third parties such as employees, shareholders and junior creditors. In such cases, the alternative of a conditioned stay will represent an attractive means of reaching a compromise. With regard to the important question of what conditions should be imposed as a prerequisite to

108. Under the existing Bankruptcy Act the court is to consider three criteria in determining whether to vacate a stay in a rehabilitative bankruptcy proceeding: (1) the possibility of a successful reorganization; (2) the debtor's need for the property; and (3) the material harm to the creditor if the stay is continued. Caplan v. Anderson, 256 F.2d 416 (5th Cir. 1958); 8 W. COLLIER, BANKRUPTCY ¶ 3.22 (14th ed. 1975); 11 H. REMINGTON, BANKRUPTCY ¶ 4393 (rev. 1961); see text accompanying notes 65-67 supra. Presumably the Commission did not intend to dispense with these considerations, although the text of the Proposed Act specifically mentions only the last.
continuing the stay, the Commission's Note\(^\text{110}\) indicates that the matter is to be left to "case by case development by the courts."\(^\text{111}\)

The Note does suggest, however, some conditions the court may impose. The Commission recommends that the debtor be required to give alternative security either in an amount sufficient to protect the secured creditor against the decrease in value of depreciable collateral or in complete substitution for the creditor's existing security.\(^\text{112}\) The first alternative seems preferable in that complete substitution is more appropriately incorporated in the plan of reorganization because a more careful inquiry into the fairness of the proposed substitution is possible at that time.\(^\text{113}\) Requiring additional security to compensate the secured creditor for depreciation or partial use of his collateral is a common basis for settlement of disputes between secured creditors and debtors under existing law. Nonetheless, there are several reasons why the additional security approach is not a cure-all. Due to the simple means of obtaining broad security interests under the Uniform Commercial Code, the debtor in extremis will already have encumbered virtually every asset of value. Moreover, care must be taken to avoid giving too much or too little additional collateral, and the urgency and confusion of the first few days of a rehabilitative proceeding are hardly the time for the careful reflection necessary to do the job properly. The use of additional security may substantially strengthen an otherwise weak position held by a secured creditor. What is intended, of course, is not to bail out the partially secured creditor, but simply to protect him from further damage. Finally, it should be recognized that reasonable minds will differ concerning the "value" of a partially completed construction project or an inventory of partially completed electronics equipment.

Another alternative suggested by the Commission involves giving a

\(^{110}\) Proposed Act, supra note 7, § 7-203, Note 3.

\(^{111}\) Where the authorized or unauthorized use of collateral results in a loss to the creditor, under existing law the sacrifice of the secured creditor does not go completely uncompensated. In re Yale Express System, Inc., 384 F.2d 990 (2d Cir. 1967); In re New York, New Haven & Hartford Ry., 147 F.2d 40 (2d Cir.), cert. denied, 325 U.S. 884 (1945); Murphy, supra note 5, at 36-38. First, it is a long-recognized principle of trust law that those who contribute to the preservation of a fund in the custody and control of a court are entitled to a first charge on the corpus. See Adair v. Bank of America National Trust and Savings Assn., 303 U.S. 350 (1938). Secondly, in the context of Chapter X there is limited case support for compensating the secured creditor on a priority basis at the time of confirmation. In re Yale Express System, Inc., supra. Again, this presupposes that there will be a confirmation. See note 71 supra and accompanying text. Finally, sections 64a(1) and 344 of the existing Bankruptcy Act appear to permit priority status in Chapter XI proceedings for claims based on contributions of property. Bankruptcy Act §§ 64a(1), 344, 11 U.S.C. §§ 104(a)(1), 744 (1970).

\(^{113}\) Proposed Act, supra note 7, § 7-203, Note 3.

\(^{113}\) See Id. §§ 7-303, 7-306.
priority claim to the secured creditor.\textsuperscript{114} This method of compensating a secured creditor damaged by a stay has received judicial support\textsuperscript{115} and has even been suggested as a justification for refusing to permit a secured creditor to foreclose where the prospect of harm was virtually certain.\textsuperscript{116} However, granting a priority just postpones the day of reckoning until the date of confirmation of the debtor’s plan and, in turn, presupposes that a plan will be confirmed. The Commission attempted to deal with the problem of granting an ephemeral future priority as a device for avoiding present reality by suggesting that this solution should be indulged in only where a finding is made that adequate assets exist to make such a priority meaningful. Presumably, after making such a finding and award, the court would not permit debtor transactions that would result in taking back what has been given. Erosion of the secured creditor’s position could occur, for example, when the class of priority claimants was diluted to the point where the assets were no longer sufficient to pay them all in full.

It is important that the court view the property of the debtor in a liquidation context in determining the value of the priority given the secured creditor. The granting of a priority claim is in the nature of a guarantee to the creditor that it will suffer no loss. The guarantee becomes operative either in the event of the confirmation of a plan (in which case there are enough assets to assure payment of the creditor) or upon liquidation of the debtor. Therefore, it is the liquidation value of the collateral which should determine the amount of the creditor’s priority claim.\textsuperscript{117}

Another possible condition for the continuation of the stay, one which the Commission failed to suggest, is to require the debtor to make interim cash payments to the creditor in an amount sufficient to compensate the creditor on a present basis for its anticipated loss. This was the approach adopted in \textit{In re Bermec Corp.}\textsuperscript{118} and has been the basis

\begin{itemize}
\item \textsuperscript{114} \textit{Id.} § 7-203, Note 3.
\item \textsuperscript{115} See text accompanying note 71 \textit{supra}.
\item \textsuperscript{116} \textit{Id.}
\item \textsuperscript{117} Compare text accompanying notes 132-35 \textit{infra}.
\item \textsuperscript{118} 445 F.2d 367 (2d Cir. 1971). See note 72 \textit{supra}. The Commission’s Note suggests that section 7-203 is intended to be a codification of cases such as \textit{In re Bermec} and \textit{In re Yale Express System, Inc.}, 370 F.2d 433 (2d Cir. 1966) and 384 F.2d 990 (2d Cir. 1967). \textit{Proposed Act, supra} note 7, § 7-203, Note 1. By providing for conditions which will “adequately protect” the secured creditor in section 7-203, it appears
of most of the settlements between secured creditors and trustees, receivers and debtors under the existing Bankruptcy Act. Despite the attraction of the interim cash payments alternative, it is deceptively simple in several respects. To begin with, most secured financing is sufficiently generous that the scheduled payments approximate the depreciation of the collateral. If the debtor could have made the scheduled payments, it is likely that no proceeding under the Bankruptcy Act would have been necessary in the first place. Second, the court must decide whether the size of the payments should be based on liquidation value of the collateral or its fair market value, fair equivalent value or some other standard. Since it is unlikely the valuation will be exact, it would seem preferable to err on the high side. No real harm is done if the payments are in excess of the amount necessary to protect the secured creditor since each payment increases the debtor's equity in the collateral, which in turn benefits general creditors. Third, if the interim cash payments alternative is used, perhaps the secured creditor should receive interest or compensation for its cost of funds.

This last idea may seem shocking at first because it has been long recognized in bankruptcy that a secured creditor is entitled to the payment of interest only in the event that it holds surplus security above the amount necessary to cover principal. If there is extra security, the rights of the secured creditor are not being jeopardized and interim payments are unnecessary. Nevertheless, the secured creditor in effect receives interest under the present Bankruptcy Act when the debtor in a Chapter XI proceeding just continues to pay his secured obligations substantially according to their terms or works out an alternative payment schedule. If the stay of the marginally secured creditor is properly viewed as an involuntary loan of property to the debtor, there seems little reason not to afford the secured creditor some protection against the ravages of inflation and the fact that his own creditors have not given him an interest moratorium.

that the Commission did not intend to go as far as the court went in Yale Express. However, the concept of interim cash payments, as adopted in Bermec, is not among the suggested means of protecting the secured creditor. Proposed Act, supra note 7, § 7-203, Note 3.

119. In a majority of cases the immediacy of the problem is such that neither side can afford to litigate the matter.

120. Wright v. Union Central Life Ins. Co., 311 U.S. 273 (1940), is silent as to the meaning of the word "value," although from the context of the Frazier-Lemke Act, Act of Aug. 28, 1935, ch. 792, 49 Stat. 942, it seems clear that fair market value was intended. Fair market value is difficult to determine where the continuance of the debtor as a going concern is a prerequisite to realization of the value.

121. 2 H. Remington, Bankruptcy §§ 726-27 (rev. 1961). To the extent that collateral exceeds the principal sum owed, the interest charge is secured. The creditor is entitled to apply the excess collateral to the interest charge on the debt.
In addition to the proposals just outlined, other alternatives are available. These alternatives, however, would involve a major rethinking of the role of the government as an active proponent of business rehabs. For example, one suggestion is to reimburse the secured creditor by giving a credit against income tax.\textsuperscript{122} This idea presupposes that the creditor will be paying income tax, by no means a certainty, and presupposes a precise valuation of the secured creditor's position at the time of confirmation. In reality, the treatment of secured creditors upon confirmation approximates frontier justice and is not sufficiently exact to form a basis for tax treatment. Another alternative, from time to time popular as a means of avoiding major business failures, is a governmental guaranty. However, creation of a broad-based relief organization may result in wasting substantial sums on the numerous hopeless cases that dot the bankruptcy scene. On the other hand, approaching the matter on a case by case basis, as has been done,\textsuperscript{123} may mean that only the largest debtors will have any hope of receiving relief.

A major consideration in drafting new bankruptcy legislation is whether Congress should attempt to outline the primary means of protecting the position of the secured creditor or simply leave the matter to judicial invention as the Commission has done. It has been suggested that the criteria set forth in the Commission's Note to section 7-203 should be incorporated in the statute itself since, upon enactment of the new legislation, the Commission's Notes will not even be as authoritative as legislative history.\textsuperscript{124} Unlike the Uniform Commercial Code, which has a continuing editorial board whose official comments constitute some persuasive authority,\textsuperscript{125} the Commission is no longer in existence and its Notes will have no official status with respect to the final legislation that emerges from Congress. It is not likely that the Commission's Notes will be used to fill gaps in statutory drafting, because they are nothing more than the Commission's working comments and do not contain provisions for being updated. Perhaps the best arguments for including specific statutory language are the relative timidity of courts in dealing squarely with the issue of conditioned use of collateral under existing law where there is a clear power to act,\textsuperscript{126} confusion over what

\begin{itemize}
\item \textsuperscript{122} Rosenberg, Beyond Yale Express: Corporate Reorganization and the Secured Creditor's Rights of Reclamation, 123 U. Pa. L. Rev. 509 (1975).
\item \textsuperscript{124} Coogan, Broude and Glatt, supra note 16, at 100.
\item \textsuperscript{125} See, e.g., Evans v. Everett, 279 N.C. 352, 183 S.E.2d 109 (1971).
\item \textsuperscript{126} Evans v. Everett, 279 N.C. 352, 183 S.E.2d 109 (1971).
\end{itemize}
tests should be applied where it has been determined that the power to permit such use exists, and the peculiar distinction with respect to the judicial power between Chapter X and Chapter XI proceedings.

Suggested language incorporating the alternatives discussed while leaving adequate room for judicial invention is as follows:

Relief from or Modification of Stay. Pursuant to the Rules of Bankruptcy Procedure and section 4-501(c), the secured party or lessor may file a complaint (1) to terminate the stay, or (2) to modify the stay by requiring (i) the making of interim cash payments to the secured party or lessor by the trustee, receiver or debtor, (ii) the giving of additional or replacement security to the secured party to the extent of the reasonably anticipated decrease in value of the collateral by reason of its use, (iii) the giving of a priority claim if it is clear that the sufficient unencumbered assets exist to pay such claim in the event of a liquidation or (iv) such other relief as will, under and consistent with the circumstances of the particular case, equitably and fairly provide for the realization by such secured party or lessor of the value of its collateral or property.

E. The trustee or the debtor shall have the burden of proving that the value of the secured creditor's interest in the property or the property leased as of the date of the petition is adequately protected.

The meaning of the word "value" will be crucial in many cases under the Proposed Act, just as it has been a difficult question under the current Bankruptcy Act. Bankruptcy courts have wrestled with valuation in determining solvency for preference or fraudulent conveyance purposes and for absolute priority rule purposes. The question is whether "value" means fair market value, fair equivalent value, liquidation value or some other determination.

The Commission's Note, suggesting that "[a] benchmark in determining the adequacy of protection is the liquidation value of the collateral at the date of the petition," seems ill-advised. Most secured creditors, at one time or another, have faced the disturbing reality that their only hope for recovery is to keep the debtor going since their

127. Compare In re Third Avenue Transit Corp., 198 F.2d 703 (2d Cir. 1952), with In re Yale Express System, Inc., 370 F.2d 433 (2d Cir. 1966) and 384 F.2d 990 (2d Cir. 1967).
128. See text accompanying notes 20-38 supra.
129. See, e.g., Edward R. Bacon Co. v. Grover, 420 F.2d 678 (9th Cir. 1970), where it was held that for the purposes of determining solvency of a business, assets must be valued as those of a going concern. See generally, 1 W. COLLIER, BANKRUPTCY ¶ 1.19[3] (14th ed. 1974).
131. Proposed Act, supra note 7, § 7-203, Note 3 (emphasis added).
accounts, inventory or equipment collateral will bring only a fraction of book value if a liquidation occurs. At one end of the scale, collateral may liquidate at a figure approximating book value where inventory consists of consumer accounts receivable or products for which there is a market without an ongoing maintenance requirement. On the other hand, an inventory of sophisticated electronic equipment or accounts due from account debtors who are entitled to future services will often liquidate at a relatively small percentage of book value. Furthermore, the word “liquidation” is imprecise in itself. Obviously property of the debtor is liquidated in the course of business by ultimate sale or lease to customers at what is presumably fair market value. Alternatively, property may be liquidated by being sold at a discount but in a gradual and orderly manner which yields a return only slightly less than book value. To most lenders, however, the word “liquidation” connotes a foreclosure sale in the case of tangible personal property or real estate and implies direct notification of account debtors in the case of accounts.

It has been suggested that the use of the word “liquidation” by the Commission is unfortunate, and that if “a secured party is to be compelled to forego enforcement of his rights in order to preserve going concern value, that value should enter into this calculation.” That is, since the creditor is forced to forego contract payments in order to keep the debtor’s business viable, the creditor should be protected to the extent of the going concern value of the collateral. This is consistent with the threshold requirement that the court not permit continued operations where no plan is possible. Assuming one of the issues at the hearing upon the secured creditor’s complaint would be whether the debtor is capable of continuing operations as a going concern, then—if that question is answered in the affirmative—it would be inconsistent to treat the secured creditor with some other assumption in mind.

The requirement that the trustee or debtor shall have the burden of proving that the secured creditor’s interest is adequately protected is consistent with existing law under the Bankruptcy Rules. For all practical purposes, any secured creditor who waits for the debtor to establish the grounds for continuance of a stay, and who makes no case of his own, is likely to be disappointed. It is well recognized by secured creditors that due to the pressures favoring continued operations, any complaint seeking permission to foreclose, if the foreclosure will have

---

133. See Proposed Act, supra note 7, § 7-112.
134. Id. § 7-203(b).
135. Compare text accompanying note 117 supra.
136. BANKR. R. 10-601, 11-44, 12-43. It has been suggested that, at least prior to the effective date of the Rules, the burden in Chapter X proceedings was on the secured party. 6 W. COLLIER, BANKRUPTCY ¶ 6.12 (14th ed. 1972).
the practical effect of forcing an adjudication, will have to be supported by an overwhelming showing of either material harm to the creditor or the utter hopelessness of continued operations. There is no reason to suppose that the state of affairs under the new statute will be materially different. Since the creditor must exercise the initiative by raising the issue by complaint,\textsuperscript{137} and since the creditor faces a difficult task of persuasion, there is no reason to require him to bear the burden of proof. The debtor is likely to have access to evidence demonstrating protection of the collateral, and it is the debtor which is the party seeking relief from its contractual obligations.

Finally, the Commission suggests that the value of the collateral be measured as of the date of the petition.\textsuperscript{138} This recommendation is consistent with the constitutional rights of the secured party or lessor\textsuperscript{139} and recognizes the impropriety of exposing the creditor to the risk of value erosion that might occur after the petition has been filed.

The change suggested for the last sentence of section 7-203 would make it clear that the value of the secured creditor's collateral should be measured on a going concern basis:

The trustee, receiver or debtor shall have the burden of proving that the value of the secured party's or lessor's interest in the collateral or property as of the date of the petition is adequately protected, such value to be determined on a going concern basis.

\textbf{IV} \\
\textbf{INTERIM REMEDIES AND CONFIRMATION}

The usefulness of Chapter XI under the current Bankruptcy Act is substantially impaired by the inability of the debtor to present a plan providing for an alteration or modification of the rights of secured creditors. The result is that a debtor faced with secured creditor problems is left with a Hobson's choice: either accept the extreme remedy of a Chapter X proceeding with its inherent expense, delay and loss of control, or file a Chapter XI proceeding, recognizing that the secured creditor must be paid in full if it cannot be brought to compromise. In section 7-303, of the Proposed Act, setting forth the provisions of a plan of reorganization, the Commission has adopted a counterpart of sections 216 and 461 of the existing Bankruptcy Act.\textsuperscript{140} It would permit the debtor to propose a plan altering or modifying the rights of secured

\textsuperscript{137} Proposed Act, \textit{supra} note 7, § 7-203(b).
\textsuperscript{138} \textit{Id.}
\textsuperscript{139} \textit{See} Wright v. Union Central Life Ins. Co., 311 U.S. 273 (1940).
creditors without their consent while preserving the informality of the present Chapter XI. This change was mandated by the broad security interests encouraged under the Uniform Commercial Code, which generated a hopeless impasse in many Chapter XI proceedings.

However, the scope of the alteration or modification of the secured creditor's rights under section 7-303 is a subject of substantial uncertainty. The modification could consist of a reinstatement of the secured obligation on the same terms that existed prior to default. It may result in a rewriting of the obligation on terms more generous to the debtor, or it may involve transferring the secured creditor's lien from one item of collateral to another. A power this sweeping can be the object of real abuse; and, in the early part of this century, similar abuses in equity receiverships (the diversion of values to junior interests) led to the development of the "absolute priority rule" enunciated by the Supreme Court in Northern Pacific Railway v. Boyd. The Commission's Note to section 7-303 is likely to concern those who believe that the absolute priority rule is necessary to prevent improper treatment of senior interests, secured or otherwise, in Chapter VII proceedings under the proposed legislation. The Note indicates that cases such as Preble Corp. v. Wentworth, which held that appraisal could not be used as a device to pass values to junior interests, would be superseded by section 7-303(7).

The problem of appraisal is at the heart of the treatment of secured creditors in bankruptcy reorganization proceedings. If it is accepted that the secured creditor should not be able to insist on a repossession and sale of its collateral, then the question is how to carry out the process of rehabilitation while preserving the integrity of secured transactions. Where the creditor is less than fully secured, the valuation of that security at the time of confirmation is very difficult; yet it is necessary in order for the court to pass upon the proposed treatment of the creditor in the plan. The dilemma is that giving the secured creditor too much leverage will result in the creditor's ability to extract unfair concessions with respect to the unsecured portion of its claim, while under-appraisal will permit the debtor to divert the creditor's security to junior interests.

Under section 7-303(9) various means of executing the plan of reorganization are set forth including, inter alia, the satisfaction or

141. See Wachovia Bank & Trust Co. v. Harris, 455 F.2d 841 (4th Cir. 1972), where a short-term construction loan of 6 months duration became a 20-year "permanent" loan.
143. 84 F.2d 73 (1st Cir.), cert. denied, 299 U.S. 575 (1936).
144. Proposed Act, supra note 7, § 7-303, Note 9.
145. See text accompanying notes 49-52 supra.
modification of liens, sales of property free and clear of or subject to liens, the cancellation or modification of indentures or other similar instruments, the curing or waiver of defaults, extension of maturity dates, and changes in interest rates. The Commission has provided that defaults may be cured and that, in appropriate circumstances, maturity dates may be extended beyond those afforded in the original agreement between the parties. The latter power must be exercised sparingly to prevent abuses by debtors attempting to renegotiate their contracts with their secured creditors. Section 7-303(9) also provides for use of sales subject to liens or sales free and clear of liens as a means of dealing with secured creditors. This is not a new idea, however. The power of the bankruptcy court to sell property in its custody and control has been settled since the decision of the Supreme Court in Van Huffel v. Harkelrode. As a corollary of the power of sale, however, the debtor or trustee should have the power to reinstate defaulted obligations and to extend maturity dates where the lien is upon property the debtor intends to sell.

If the right to alter or modify the claims of secured creditors under section 7-303 is to be meaningful and equitable, two problems must be addressed.

First, a power that appears to be necessary, but which has not been clearly provided for, is the power to adjust liens. The secured creditor should be forced to marshal its security and, in some circumstances, to accept alternative security if its refusal to do so would impede rehabilitation. The concept is similar to giving "other security of an equivalent value" under section 7-203. Second, it is debatable whether, as the

---

146. Proposed Act, supra note 7, § 7-303(9). The language of the Judges' Bill, supra note 8, § 7-301 is substantially the same with respect to Chapter VII reorganizations. However, with regard to Chapter VIII arrangements, the Judges' Bill provides: [The plan] may include provisions dealing with claims secured by personal property severally, on any terms, and may provide for the curing of defaults within a reasonable time and otherwise alter or modify the rights of the holders of such claims, and may include provisions for the curing of defaults within a reasonable time and the maintenance of payments on claims secured by a lien on real property used in connection with the debtor's business: Provided, However, That it shall not be necessary in order to cure a default to make any payment due solely under a clause accelerating the obligation for nonpayment of any installment on a contract, whether or not the acceleration occurs before or after the initiation of a case under this chapter.

Id. § 8-301(2).

147. Proposed Act, supra note 7, § 7-303(9)(G).

148. Id. § 7-303(9)(H).

149. The dissent in Wachovia Bank & Trust Co. v. Harris, 455 F.2d 841 (4th Cir. 1972), vigorously criticizes the result for exactly this reason.

150. Proposed Act, supra note 7, § 7-303(9)(D).

151. 284 U.S. 225 (1931).

152. Proposed Act, supra note 7, § 7-203, Note 3. See text accompanying note 113 supra.
Commission provides, the court should have the power to reduce the rate of interest on a secured obligation. A large part of secured financing available to business debtors is based on a carefully calculated balancing of return and cost of funds. Any provision in a plan forcing a fully secured creditor to accept a materially reduced rate of interest may work a real hardship upon the secured creditor and may be unconstitutional as well. To the extent that the interest rate is usurious or unconscionable, the trustee, receiver, or debtor will have ample grounds upon which to seek relief offered elsewhere in the Proposed Act.

While no effort is made here to offer suggested new language for section 7-303, it must be recognized that both section 7-203 and section 7-303 deal with substantive alterations and modifications of the rights of secured creditors. It is important that the same tests and standards be applicable to each. One of the peculiarities of cases under Chapter X of the current Bankruptcy Act is the willingness of the court to permit treatment of the secured creditor at the outset of the proceeding that the court would not permit at the time of confirmation. This discrepancy should be avoided under the new legislation so that the creditor can operate under the same ground rules and the debtor can receive the same type of relief at the outset of the proceeding as he can receive at the time of confirmation. The concept of confirmation under section 7-303 should involve assumption of the creditor-debtor alterations already made under section 7-203, backed up by a "permanent injunction" — the binding effect of a confirmed plan. Accordingly, section 7-303 should be redrafted to make it generally consistent with the approach taken in section 7-203.


154. This would depend upon the secured creditor's own source of financing.

155. The secured creditor possesses a constitutional right to have the value of its security protected to the extent of the obligation. Wright v. Union Central Life Insurance Co., 311 U.S. 273 (1940). The obligation presumably includes interest at the contracted rate.

156. See, e.g., Judges' Bill, supra note 8, §§ 4-403(b)(8) and 4-403(c), which provide a basis for disallowing unconscionable claims.

157. Compare Country Life Apartments, Inc. v. Buckley, 145 F.2d 935 (2d Cir. 1944), where the court upheld a plan of reorganization upon a finding that creditor's rights were "adequately protected," with In re Yale Express System, Inc., 370 F.2d 433 (2d Cir. 1966) and 384 F.2d 990 (2d Cir. 1967), where the same court permitted treatment of the secured creditor at the outset of the proceeding that would have been wholly inconsistent with the adequate protection test to be applied at the time of confirmation. Murphy, supra note 5, at 33-34.

158. See Proposed Act, supra note 7, § 7-311.
CONCLUSION

The Proposed Act represents substantial progress in the clarification of the law with respect to the treatment of secured creditors in bankruptcy rehabilitation proceedings. In addition, however, the proposed legislation should anticipate and expressly deal with some major problems which have arisen under Chapters X, XI and XII of the existing Bankruptcy Act. The drafting revisions suggested in this Article would more clearly establish the ground rules to be applied in resolving debtor-creditor disputes and would provide a vehicle for positive restructuring of a debtor’s secured obligations throughout a rehabilitative proceeding.