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Bankruptcy

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BANKRUPTCY

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Matters of bankruptcy concern occurred in three principal areas during the past year. First, the bankruptcy court system and Congress continued to struggle with the problems created when the United States Supreme Court ruled that much of the jurisdictional basis for the current system was unconstitutional. Second, the Louisiana Legislature changed the treatment some Louisiana lenders can expect in bankruptcy by passing the new Assignment of Accounts Receivable Act. Finally, the United States Fifth Circuit Court of Appeals and the Louisiana appellate courts addressed the complications that result when bankruptcy law requires that the debtor's affairs be severed from those of his co-debtors and of the coowners of the property chargeable with his debts.

JURISDICTION

The Bankruptcy Reform Act of 1978 granted to the federal district courts jurisdiction over all bankruptcy proceedings[1] and then decreed that the granted power would be exercised not by the district courts themselves, but rather by the bankruptcy courts.[2] In June 1982, the United States Supreme Court in *Northern Pipeline Construction Co. v. Marathon Pipe Line Co.*[3] held that the bankruptcy court's exercise of this jurisdiction over certain disputed matters violated article III of the United States Constitution. Article III requires that the judicial power of the United States be exercised by judges with life tenure who face no prospect of having their salaries diminished while in office.[4] The bankruptcy judges, with limited tenure[5] and potentially adjustable salaries,[6] do not meet those article III qualifications. However, the Supreme Court expressly stayed entry of its mandate until October 4, 1982, in order to permit Congress to amend the Act and repair the deficiency.[7] Upon request of the United States Solicitor General, the Court further extended the stay until December 24, 1982.[8] A third request for an additional three-month stay was subse-

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1. 28 U.S.C. § 1471(a) (Supp. V 1981).
2. 28 U.S.C. § 1471(c) (Supp. V 1981).
3. 458 U.S. 50 (1982).
4. U.S. CONST. art. III, § 1.
5. 28 U.S.C. § 153 (Supp. V 1981).
6. 28 U.S.C. § 154 (Supp. V 1981). Salaries of bankruptcy judges are "subject to adjustment under section 225 of the Federal Salary Act of 1967, (2 U.S.C. 351-361), and section 461 of this title." *Id.*
7. 458 U.S. at 88.
8. Northern Pipeline Constr. Co. v. Marathon Pipe Line Co., 103 S. Ct. 199 (1982).

quently denied,[9] leaving the bankruptcy system in a constitutional limbo. In the meantime, another crisis looms next spring when, on March 31, 1984, the terms of office of all the existing bankruptcy judges expire.[10]

To plug the gap, the district courts have adopted a so-called "temporary-emergency rule" drafted by the Judicial Conference of the United States.[11] Under the rule, the district courts, staffed with true article III judges, purport to take back jurisdiction from the bankruptcy courts. The district courts then redelegate part of their power to the bankruptcy judges, using procedures which preserve the right of claimants and other parties to the bankruptcy to have certain issues (presumably those required by article III) reviewed or tried in district court.[12] The basic business of the bankruptcy courts operating under the temporary emergency rule has been conducted very much as it was before the *Marathon* decision became effective. No one, however, is comfortable with the temporary solution.[13] It is not entirely clear, for example, that the district courts had the authority to adopt the temporary rule. For one thing, it may violate the command in the Bankruptcy Act that bankruptcy jurisdiction be exercised by the bankruptcy courts.[14] Even though the command is unconstitutional, it does not necessarily follow that Congress intended to empower the district courts to act as backstops when the primary scheme fell. Additionally, even if Congress had authorized the temporary solution, no one is sure that courts can accomplish by rule what Congress could not constitutionally accomplish in the statute.[15] Until Congress acts, or the rule survives all the possible challenges, the orders and judgments which emerge from the bankruptcy process will be subject to question.

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9. Northern Pipeline Constr. Co. v. Marathon Pipe Line Co., 103 S. Ct. 662 (1982).

10. Bankruptcy Reform Act of 1978, Pub. L. No. 95-598 § 404(b), 92 Stat. 2549, 2683 (1978).

11. *See* S. REP. No. 55, 98th Cong., 1st Sess. 1 (1983).

12. The Judicial Conference Rule is reported in full in D. COWANS, BANKRUPTCY LAW AND PRACTICE 1214-17 (Interim ed. 1983). It was adopted by the Middle District of Louisiana on December 22, 1982. M.D. LA. R. 29.

13. *See, e.g.*, Fullerton, *No Light at the End of the Pipeline: Confusion Surrounds Legislative Courts*, 49 BROOKLYN L. REV. 207 (1983); King, *The Unmaking of a Bankruptcy Court: Aftermath of Northern Pipeline v. Marathon*, 40 WASH. & LEE L. REV. 99 (1983); Levit & Mason, *Where Do We Go From Here? Bankruptcy Administration Post-Marathon*, 87 COM. L.J. 353 (1982); Vihon, *Delegation of Authority and the Model Rule: The Continuing Saga of Northern Pipeline*, 88 COM. L.J. 64 (1983); H.R. REP. No. 9, 98th Cong., 1st Sess. 3 (1983).

14. The source of rule-making authority in the district courts is found in 28 U.S.C. § 2071, which states: "The Supreme Court and all courts established by Act of Congress may from time to time prescribe rules for the conduct of their business. Such rules shall be consistent with Acts of Congress and rules of practice and procedure prescribed by the Supreme Court." It remains to be seen whether the rule which places jurisdiction back into the district courts is "consistent" with the Act's requirement that the power be reposed in the bankruptcy court.

15. *See* Braniff Airways v. Civil Aeronautics Bd., 700 F.2d 214 (5th Cir.), *cert. denied*, 103 S. Ct. 2122 (1983); *see, e.g.*, King, *supra* note 13.

Meanwhile, both houses of Congress have been working on more permanent repairs to the bankruptcy system. The 1978 Act was the result of a ten-year effort involving a great number of political compromises.[16] In fact, the now invalid jurisdictional provisions of the statute were the result of a House-Senate conference committee report resolving the conflict between the preferences of the House that bankruptcy judges be given true article III rank, and those of the Senate that bankruptcy judges be given more limited status.[17] The Senate has passed and referred to the House a repair measure entitled The Bankruptcy Court and Federal Judgeship Act of 1983, which continues the fourteen-year term of appointment for bankruptcy judges,[18] leaves their salaries potentially adjustable[19] and continues the provisions of the present Act which empower the judicial conference to remove them from office for incompetency, misconduct, or disability.[20] The bill, like the current Act, provides that all bankruptcy matters be automatically referred to bankruptcy judges.[21] The new scheme attempts to clear the *Marathon* hurdle by specifically authorizing the article III judges of the district court to exercise bankruptcy jurisdiction. The bill requires that certain matters be "recalled" from the bankruptcy court and heard in district court. Such recalls are mandatory under the bill when the Constitution requires that the issues involved be tried before an article III judge.[22] Parties may, under the bill's terms, consent to have their disputes tried in bankruptcy court instead of on recall.[23] The bill further authorizes the district judge to refer recalled matters back to the bankruptcy judges, who will thereafter function as special masters or magistrates.[24] The House is considering reverting to its initial position. A bill styled the Bankruptcy Court Act of 1983, which upgrades the status of bankruptcy judges to the article III level, has passed the House Judiciary Committee and is currently pending before the full House.[25]

Once one of the original political trade-offs becomes unwound, it would not be surprising if some of the other issues compromised in 1978 also are reopened. On the same day that the Senate passed the bill deal-

16. *See* Klee, *Legislative History of the New Bankruptcy Law*, 28 DE PAUL L. REV. 941 (1979).

17. *See* Conley, *Developments in the Law, 1981-1982—Bankruptcy*, 43 LA. L. REV. 327, 328-29 (1982).

18. S. 1013, 98th Cong., 1st Sess. § 201 (1983).

19. S. REP. No. 55, 98th Cong., 1st Sess. 44, 50 (1983); *see supra* note 6.

20. *See* 28 U.S.C. § 153 (Supp. V 1981).

21. S. 1013, 98th Cong., 1st Sess. § 102 (1983).

22. *Id.*

23. *Id.*

24. *Id.* Some doubt over the validity of such referrals back to bankruptcy judges may arise as a result of Pacemaker Diagnostic Clinic of America v. Instromedix, Inc., 712 F.2d 1305 (9th Cir. 1983) (held that the Federal Magistrate Act is unconstitutional because it also delegates judicial power to non-article III judges).

25. *See* H.R. 3, 98th Cong., 1st Sess. (1983).

ing with the *Marathon* problem, it passed a companion measure styled the Omnibus Bankruptcy Improvements Act of 1983.[26] The provisions of that bill attempt to significantly improve the rights of creditors, particularly consumer creditors, over the comparable rights given in the 1978 reform act. The bill, if finally enacted by both houses of Congress, would also make significant changes in the bankruptcy treatment of grain elevator failures, shopping center leases, timber contracts, and other matters which, in the Senate's view, have been troublesome under the 1978 Act.[27] It is too early to predict the extent to which such proposals for change will become linked to the political compromises necessary to resolve the fundamental constitutional defects in the 1978 Act. It does seem reasonable to assume, however, that some significant changes in the Act itself will accompany any Congressional solution to the current constitutional crisis.

BANKRUPTCY CONSEQUENCES OF THE NEW ASSIGNMENT OF ACCOUNTS RECEIVABLE ACT

Debtors suffering financial difficulties generally exhaust their assets prior to filing for bankruptcy. During the downhill slide, aggressive creditors get partial or full payments. In efforts to raise funds, debtors sell or encumber their assets. Frequently part or all of the debtor's property is seized to satisfy judgments. When bankruptcy occurs, there is little, if any, residue with which to pay the remaining unsecured creditors, unless some of the eleventh hour payments can be brought back into the bankrupt's estate, or unless some of the encumbrances can be avoided.[28] Consequently, the real "action" in a bankruptcy proceeding usually involves attempts by the bankruptcy trustee to recover prebankruptcy payments and other transfers made to creditors which were either fraudulent or preferential, or to invalidate the security devices obtained by secured creditors.

Creditors taking assignments of accounts receivable as collateral for their loans have been vulnerable to such actions by bankruptcy trustees for a rather complicated set of reasons. At its latest session, the Louisiana Legislature revised the Assignment of Accounts Receivable Act.[29] One of the effects of the revisions is to decrease the vulnerablity of such lenders to bankruptcy losses.

26. *See* S. 445, 98th Cong., 1st Sess. (1983); 129 CONG. REC. S5388 (daily ed. Apr. 27, 1983).

27. *See* S.445, 98th Cong., 1st Sess. (1983).

28. Under the old act 85% of all bankruptcies yielded no dividends to unsecured creditors. The 15% which did pay yielded an average of five cents on the dollar to holders of unsecured claims. *See* ADMINISTRATIVE OFFICE OF THE UNITED STATES COURTS, TABLES OF BANKRUPTCY STATISTICS, tables F-4a, -6 (1978); Countryman, The Bankruptcy Boom, 77 HARV. L. REV. 1452, 1453 (1964).

29. 1983 La. Acts, No. 319, § 1, *amending* LA. R.S. 9:3101-:3111 (1983).

The Typical Accounts Receivable Financing Deal

Merchants, professionals, and other businessmen typically find that selling on credit is advantageous. Credit sales, however, require additional capital because the businessman must pay for his inventory, labor, rent, overhead, and other expenses connected with his sales before he receives from his clients and customers the revenues those sales generate. Frequently, banks or other lenders are willing to supply this additional required working capital, taking security interests in the promises of the borrower's customers to pay for the goods or services they have received. Since it is often possible for the borrower to collect the accounts more efficiently than the lender (for, among other reasons, the borrower often maintains continuing business relationships with his credit customers), such loan agreements may contemplate that the customers (account debtors) will pay the borrower directly. The customers may never even be aware that their accounts have been assigned to a lender. At intervals, the borrower will remit the amounts collected from his customers to the lender to retire the loan. Since the need for capital to finance the credit sales is a continuing one, however, many such loan arrangements contemplate that the borrower may use the collections to purchase new inventory or to finance new sales which will generate new accounts from the customers; these new accounts will continue to be subject to the lender's security interest.

Prior to 1980, the Louisiana Assignment of Accounts Receivable Act probably did not permit businesses to assign "future" accounts.[30] The Act was amended in 1980 to permit assignments of future accounts, thereby permitting Louisiana banks and borrowers to enter into financing arrangements of the sort described above.[31] Nevertheless, lenders taking assignments of accounts receivable as security for working capital loans under the 1980 law were vulnerable when their borrowers went into bankruptcy. Serious weaknesses in their position resulted from the so-called "strong-arm" provisions of the Bankruptcy Reform Act of 1978 and the provisions for avoidance of so-called preferential transfers. The new Act strengthens the lender's position in both cases.

Defeating the Strong-Arm

The first effect of the bankruptcy scheme is to freeze all rights of all creditors as of a specific date. The freeze happens primarily through the operation of section 544[32] of the Act, the so-called "strong-arm"

30. *See* Air Compressors, Inc. v. Big Chief Constr. Co., 367 So. 2d 413, 414 (La. App. 1st Cir. 1978), *writ denied*, 369 So. 2d 465 (La. 1979) (overruled on other grounds by Agrico Chemical Co. v. E.K. Painting, Inc., 432 So. 2d 253, 255 (La. 1983)).

31. *See* LA. R.S. 9:3101(9), *added by* 1983 La. Acts, No. 319, § 1.

32. 11 U.S.C. § 544 (1982).

clause.[33] The date of the freeze is the date of the commencement of the case, which occurs when either a voluntary or involuntary petition is filed.[34] As of that date, section 544, the strong-arm clause, gave the bankruptcy trustee[35] "The rights and powers of . . . a creditor . . . that obtains, at such time . . . a judicial lien on all property on which a creditor on a simple contract could have obtained a judicial lien, whether or not such a creditor exists."

The strong-arm clause affected the typical accounts receivable financing arrangement under the former law in several ways. For instance:

(1) The old accounts receivable law gave the holders of perfected assignments a priority over garnishing creditors on the accounts themselves—but only on the accounts.[36] The secured lender, therefore, still prevailed over the bankruptcy trustee exercising the strong-arm powers (which were those of a garnishing creditor) on the accounts themselves.[37]

(2) At any arbitrary point in time, however, such as the commencement of bankruptcy, much of the capital advanced in the typical financing arrangement is not tied up in unpaid accounts themselves. Significant portions are represented by funds "in the pipeline" which started when the customer pays the account. Once the customer's check to the borrower is dispatched, the account disappears.[38] The lender, however, has no security interest in the check. The strong-arm clause treats the trustee as a creditor who levies on the check, a position which defeats the lender

33. The strong arm clause was the name given to section 70(c) of the old bankruptcy act from which section 544 of the new act is derived. The effect of the freeze is further strengthened by section 362(a) of the new act which provides that the filing of a petition operates as an automatic stay of all attempts to collect debts against the debtor or his property.

34. *See* 11 U.S.C. §§ 301, 303 (1982).

35. The debtor himself, if the petition was filed not for a liquidation under chapter 7 of the Act, but rather for a reorganization under chapter 11, is given the powers of a trustee including the strong-arm power. *See* 11 U.S.C. § 1103 (1982).

36. Prior to 1980, the Louisiana Act defined *accounts receivable*, or *account* to mean "any indebtedness or part thereof due to, arising out of, or acquired in connection with any business, profession, occupation or undertaking of the assignor." *See* LA. R.S. 9:3101(1) (as it appeared prior to its amendment by 1980 La. Acts, No. 360, § 1). The 1980 amendment changed the definition to "any indebtedness . . . due to or arising out of the sale of goods or the performance of services, or the leasing of movable or immovable property." LA. R.S. 9:3101(1) (1983) (as it appeared prior to its amendment by 1983 La. Acts, No. 319, § 1). The operative provision of the old act, both before and after the 1980 amendments, was LA. R.S. 9:3102 which granted the lender rights in an "account receivable," as so defined.

37. LA. R.S. 9:3102 (1983) (as it appeared prior to its amendment by 1983 La. Acts, No. 319, § 1).

38. More precisely, the account is deemed conditionally paid until the check clears. The account would then be deemed paid retroactively to the date the check was tendered. *See, e.g., Ivy v. American Road Ins. Co.*, 409 So. 2d 549 (La. 1981); *cf.* U.C.C. § 3-802, 2 U.L.A. 601 (1977).

who had no right to the check as part of his original collateral.[39] Similarly, once the businessman/borrower receives the check and deposits it, the strong-armed trustee could take the deposit unless the borrower's bank account is set up to form additional pledged collateral for the loan. Finally, once the deposit is withdrawn to purchase new assets, the trustee can take those assets (normally new inventory or equipment), unless they are then covered by another security device (usually a chattel mortgage or an assigned vendor's lien) to shield them from a levying creditor, or the trustee, his statutory twin.

Lenders in the forty-nine other states, operating under the provisions of Article 9 of the Uniform Commercial Code, were spared part of the insecurity faced by their Louisiana counterparts, and also part of the expense of having to use multiple and cumbersome security devices such as chattel mortgages and pledged bank accounts to maintain a priority over a strong-armed trustee in funds in the pipeline. Article 9 gives secured lenders taking accounts as collateral for their loans a pipeline priority over the trustee by including the "proceeds"[40] of the accounts as part of the initial collateral (unless otherwise agreed between the lender and businessman/borrower). The new Louisiana Assignment of Accounts Receivable Act adopts the Article 9 formula.

Section 3107(A) of the new Act defines *proceeds* to include "whatever is received upon the sale, exchange, collections or other disposition of an account, *or proceeds*."[41] Under section 3107(B), "the assignee's interest in an account continues in any identifiable proceeds including collections received by the assignor"[42] (unless otherwise agreed, presumably in the original loan agreement). Finally, section 3102(C) puts teeth into the pipeline protection given to the secured lender by providing: "An assignee under a valid Notice of Assignment shall have a superior claim to the accounts assigned *and their proceeds* as against all other creditors whose claims or security arose or are perfected after the filing of the Notice of Assignment."[43] That superiority over, for example, a garnishing or levying Louisiana creditor, also turns out to be superiority over the strong-armed trustee.

The new Act will not entirely eliminate the strong-arm vulnerability of accounts receivable financing in Louisiana. The loan administration process must still be set up to permit easy identification of funds and

39. *See supra* note 36 and accompanying text.

40. *See* U.C.C. 9-306, 3 U.L.A. 436 (1977).

41. LA. R.S. 9:3107(A) (1983), as amended by 1983 La. Acts, No. 319, § 1 (emphasis added).

42. LA. R.S. 9:3107(B) (1983), as amended by 1983 La. Acts, No. 319, § 1.

43. LA. R.S. 9:3102(C) (1983), as amended by 1983 La. Acts, No. 319, § 1 (emphasis added).

assets in the pipeline as "proceeds" (the definition of which includes proceeds of proceeds). Under the old accounts receivable law, problems of security device theory and technicality had to be overcome; for example, it was necessary to determine whether the mortgage and pledge agreements were adequate in execution and filing[44] and whether a deposit account to which the borrower has convenient access is truly delivered in pledge to the lender.[45] The new Act reduces those problems to matters of simple proof: are the customers' checks "proceeds"; are they the funds in the bank account; was the new inventory purchased with those funds? To the extent that it is easier, cheaper, and safer to answer the latter questions than it was to run the former multiple security device gauntlet, the value of Louisiana accounts as collateral for loans should be enhanced. Banks can now lend more or charge less for providing this safer, typically secured working capital financing than they could in the past. If the costs to banks do decline, then the costs of borrowing businesses extending credit, and prices as well, should decline. The result will probably be small gains to a large number of Louisiana consumers who buy on credit. The expense, of course, will be borne in part by the unsecured creditors in the bankruptcies of the few Louisiana businesses that do fail.

The Preference Problem

After strong-arm cases, the most widely litigated area of bankruptcy law has been the preference problem. It is good bankruptcy policy to inhibit random dismemberment by aggressive creditors of temporarily distressed businesses.[46] Consequently, insolvency statutes frequently contain provisions which permit the trustee to force creditors to return payments they receive just prior to bankruptcy.[47] The payments recovered are then ratably distributed among all creditors, eliminating the incentive of any one of them to engage in aggressive tactics to obtain preferential treatment. One of the advantages of having a security interest has always been to avoid preference attacks by bankruptcy trustees. Insofar as payments received by secured creditors release the collateral and make it available as an asset for distribution to others, payments of secured debt generally do not prefer the security holder. Nevertheless, having secur-

44. *See, e.g.*, Air Compressors, Inc. v. Big Chief Constr. Co., 367 So. 2d 413 (La. App. 1st Cir. 1978), *writ denied*, 369 So. 2d 465 (La. 1979) (overruled by the new Assignment of Accounts Receivable Act; Exposé Des Motifs, 1983 La. Acts, No. 319).

45. *See*, Steadman v. Action Fin. Corp., 197 So. 2d 424 (La. App. 2d Cir.), *writ refused*, 250 La. 907, 199 So. 2d 918 (1967).

46. *See* Jackson, *Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain*, 91 YALE L.J. 857, 861-62 (1982).

47. *Cf.* LA. CODE CIV. P. art. 3541(2) (specifies that a debtor's intent to grant an "unfair preference" to one creditor is grounds for issuance of a writ of attachment to his other creditors); 11 U.S.C. § 96 (1976), *repealed by* Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, § 401, 92 Stat. 2549, 2682 (1978).

ity does not automatically avoid the secured creditor's vulnerability to preference attacks.

The preference provisions of the present bankruptcy act illustrate some of the problems. Trustees may avoid transfers of the debtor's property, to or for the benefit of a creditor,[48] on account of an antecedent debt,[49] made while the debtor was insolvent,[50] and during a stated period prior to bankruptcy,[51] which enables the benefited creditor to receive more than he would have received had the transfer not been made and the creditor had received instead a ratable share of the debtor's assets in a chapter 7 bankruptcy liquidation.[52] The Act then exempts certain transfers which might otherwise technically be deemed preferential.[53]

The preference provisions form some hidden traps for lenders taking accounts receivable, for example, as security. Simply taking the security interest, for example, is deemed a "transfer."[54] Loan arrangements which grant security interests in future accounts, which they typically do, actually contemplate that such transfers will happen automatically as each new account comes into being (or is increased by future credit sales by the borrower to his credit customers). Both the 1980 amendments and the new Act validate such future transfers.[55] Since the original loan was advanced long before the security interest in the "future" accounts arises, those automatic transfers are all on account of antecedent debts and, therefore, are almost automatically preferential if the accounts are created during the ninety-day (or in some cases one year) preference-vulnerability period. Accounts receivable, moreover, generally have limited lives. An account over ninety days old is likely to be simply a bad debt. It follows that the accounts which serve as collateral on the day of bankruptcy are very likely to have been paid off and renewed during the ninety-day preceding period. Thus, almost all of them will represent recent transfers subject to a preference attack.

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48. 11 U.S.C. § 547(b)(1) (1982).

49. 11 U.S.C. § 547(b)(2) (1982).

50. 11 U.S.C. § 547(b)(3) (1982). The trustee is entitled to a presumption that the debtor was insolvent for the 90 days immediately preceding the filing of the bankruptcy petitions. 11 U.S.C. § 547(f) (1982).

51. 11 U.S.C. § 547(b)(4) (1982).

52. 11 U.S.C. § 547(b)(5) (1982).

53. 11 U.S.C. § 547(c) lists six such exemptions. For a recent case construing one of them (11 U.S.C. § 547(c)(2)) exempting payments made in the ordinary course of business within 45 days after the debt arose, see *In re* Emerald Oil Co., 695 F.2d 833 (5th Cir. 1983). The case holds that payments made within 45 days after the invoice is sent are not necessarily made within 45 days after the debt arose, and, therefore, may be avoidable preferences.

54. 11 U.S.C. § 101(41) (1982).

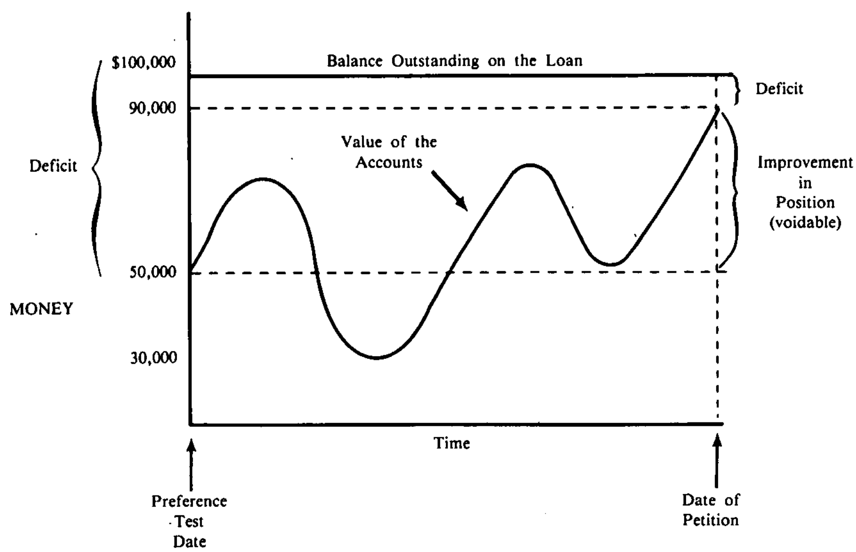
55. LA. R.S. 9:3101(7) (1983) (as it appeared prior to its amendment by 1983 La. Acts, No. 319, § 1) (old act); LA. R.S. 9:3101(9) (1983), *added by* 1983 La. Acts, No. 319, § 1 (new act).

The Bankruptcy Act, however, gives a limited exemption from preference attack to holders of security interests in accounts receivable. The trustee may *not* avoid a transfer

> of a perfected security interest in inventory or a receivable or the proceeds of either, except to the extent that the aggregate of all such transfers to the transferee caused a reduction, as of the date of the filing of the petition and to the prejudice of other creditors holding unsecured claims, of any amount by which the debt secured by such security interest exceeded the value of all security interest for such debt on the later of . . . . [The Act then defines three possible initial test dates, the most common being ninety days before the petition].[56]

In plain English, this rather tortured language means: (1) Measure the extent to which the debt exceeded the value of the collateral (*i.e.*, the accounts) on the date the petition was filed; (2) compute that same deficiency at a second date (usually ninety days but in some cases one year, and in others less than ninety days, before the petition); and (3) subtract your first number from the second one. The difference, but only the difference, is deemed a preferential transfer. In other words, lenders holding assignments of accounts receivable as security will lose their priority over the bankruptcy trustee only to the extent that their positions improved during the statutory preference vulnerability period. Figure one illustrates this situation.

Figure One



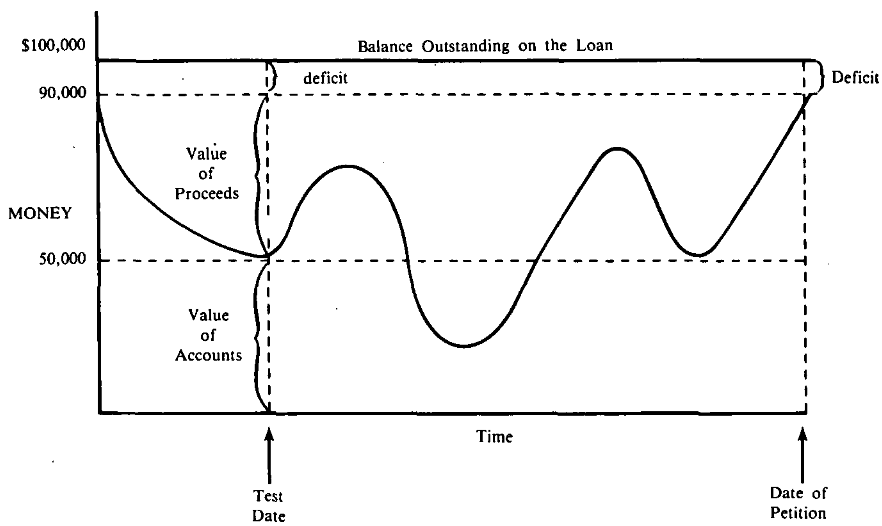
56. 11 U.S.C. § 547(c)(5) (1982).

Suppose that during the last ninety days prior to bankruptcy, the outstanding balance of the secured loans is $100,000, but the value of the collateral fluctuates from $50,000 at the test date to a low of $30,000 and then back to a high of $90,000 at the date of the petition. The creation of new accounts during the period has added $40,000 to the lender's security. While the value of the collateral sank as low as $30,000 (which means that over $60,000 of new accounts and potentially preferential transfers were created during the vulnerability period), the trustee will take only $40,000, since between the two test dates the lender's position improved by only that much.

Note, however, the possible difference that the new Assignment of Accounts Receivable Act can make. Figure two portrays that effect.

The facts illustrated here are identical to those just discussed, except that the time line has been backed up to show what may have happened prior to the initial test date. During the period prior to the measurement date, $40,000 worth of the accounts was paid by the credit customers of the bankrupt borrower. Under the new Act, however, those same customer payments, which reduce the value of the outstanding accounts receivable, can generate an equivalent amount of "proceeds" in the pipeline. Thus, at the initial test date, the total collateral securing the loans remains at the $90,000 level. The deficit is the same at the initial test date as it is at the date the bankruptcy petition is filed. There has been no improvement in the lender's position, and, consequently, none of the value of the new accounts can be avoided by the trustee.

Figure Two



A principal feature of the Louisiana law of security devices has always been its treatment of separate types of security devices under separate statutory schemes.[57] One weakness of that scheme for authorizing the taking of security is that it creates gaps between the various permitted security devices. The lender must take expensive steps to protect himself when, in the operation of the borrower's business, the collateral changes form, thus necessitating the use of a different device for each new form. In the gaps, the lender's position is jeopardized by the power granted to bankruptcy trustees. The proceeds provisions of the new Act are a first step in the process of coordinating the various Louisiana security devices and eliminating the holes between them. Were proceeds also recognized as integral parts of the collateral when chattels are mortgaged or other assets pledged, Louisiana lenders would finally be burdened with no more vulnerability in bankruptcy than are their counterparts in sister states.

The Work of the Courts

Untangling the Affairs of Bankrupts

The twin goals of bankruptcy legislation are to collect and distribute the debtor's assets to his creditors, and to discharge the debtor from those debts which remain. Neither of those goals seems conceptually complex until two possibilities arise: What happens when the debtor's "property" is only partially owned by him and what happens when other people are liable with him for his debt? Somehow, the bankruptcy process requires that the debtor's affairs be untangled from those of his coowners and his co-debtors. Problems of this type were confronted by the courts over the last year.

Co-debtors

Wedgeworth v. Fireboard Corp.[58] is one of the many asbestosis actions currently being litigated in jurisdictions around the country. The outcome of these actions became uncertain when the two principal defendants, Johns-Manville Corp.(Johns-Manville) and UNR Industries, Inc. (UNR), petitioned for chapter 11 reorganization. Following initiation of bankruptcy proceedings, all actions against Johns-Manville and UNR were automatically stayed under 11 U.S.C. § 362(a). The question then arose whether the stay precluded continuation of the suits against co-defendants of Johns-Manville and UNR. In this case, the Fifth Circuit consolidated

57. For example, chattels must be mortgaged under the chattel mortgage law. LA. R.S. 9:5351-:5366 (1983), *as amended by* 1983 La. Acts, No. 304, § 1. Pledges are governed by Civil Code articles 3133-3187. Vendors privileges fall under Civil Code articles 3227-3231.

58. 706 F.2d 541 (5th Cir. 1983).

appeals from the Western, Middle and Eastern Districts of Louisiana to consider that problem.

In a well reasoned construction of the automatic stay provision of the Bankruptcy Act, the court held that the protections of section 362 neither apply to codefendants nor preclude severance.[59] As the court points out, ample justification for the decision exists not only in the language of the statute, which only stays judicial proceedings against *the debtor*, but also in its purpose, which is to protect and prevent a run on the debtor's assets. Referring to another provision of the Bankruptcy Act not involved in this case, the court noted that Congress when it wants to can unequivocally express its intent to stay actions against co-debtors (chapter 13's stay provision applies to actions against "any individual that is liable on such debt with the debtor").[60]

The bankruptcy court below had issued discretionary stays in two of the original cases consolidated on this appeal. The Fifth Circuit on review held that considerations of the obvious hardship on plaintiffs, many of them terminally ill, and the likely length of bankruptcy proceedings outweighed the codefendants' claims of hardship. The court thus vacated the stays, finding that the bankruptcy courts had abused their discretion.

Perhaps the most significant issue of the case arose from the denials by the district court in one of the consolidated cases of plaintiffs' motion for leave to amend their complaints to assert a direct action against the liability insurers of Johns-Manville and UNR. The Fifth Circuit found plaintiffs guilty of no undue delay in suing the insurers and also found that defendants failed to prove that they would be unduly prejudiced by amendment. Since plaintiffs were not in bad faith, the court declared leave to amend to assert a direct action proper on authority of Louisiana Revised Statutes 22:655. Although cognizant of the potential advantage to Louisiana residents in allowing direct action against the Johns-Manville and UNR insurers, the court stated that "this advantage is the result of a fair and constitutional implementation of 'Louisiana's legitimate interest in safeguarding the rights of persons injured there.'"[61]

The decision seems correct. Several authorities state that where the state law allows for direct action against the insurer, the situation of the bankrupt should not affect direct actions by the creditor against the bankrupt's liability insurer.[62] Although the potential advantage to Loui-

59. *Id.* at 544.

60. 11 U.S.C. § 1301(a) (1982).

61. 706 F.2d at 547 (quoting Watson v. Employers Liability Assurance Corp., 348 U.S. 66, 73 (1954)).

62. *See* Fix v. Automobile Club Inter-Ins. Exch., 413 S.W.2d 194 (Mo. 1967); D. Cowans, Bankruptcy Law and Practice § 367 (2d ed. 1978).

siana residents is great, plaintiffs in other jurisdictions are not without recourse. Those plaintiffs may have their unliquidated claims litigated in the bankruptcy court or seek to have the stay lifted to the extent of the insured's policy limits.[63]

Co-debtors/Coowners

In *King v. Fidelity National Bank*,[64] Fidelity filed an involuntary bankruptcy petition against both Mr. and Mrs. King, although the action was presumably based on a separate debt of the husband. The Fifth Circuit held that the Bankruptcy Act granted no authority to a creditor to, in effect, put a coowner of its debtor's property into bankruptcy, and dismissed the petition with respect to the wife.

Although the *King* decision may be considered an unremarkable declaration of established law, it does raise an interesting question. Under Louisiana law, property of the marital community is liable for the debts of its members.[65] The initiation of bankruptcy proceedings would result in a stay of all proceedings against the bankrupt and the property of his estate including community property.[66] Should separate creditors of the wife, for example, be unable as a matter of law to file their claims in the husband's bankruptcy, the effect would be to give preference to one spouse's separate creditors over the separate creditors of the other spouse insofar as the community property is concerned. A close reading of the Bankruptcy Act would avoid this result.

Only "creditors" may file claims in the bankruptcy proceeding.[67] The question then arises whether the separate creditor of the nonbankrupt spouse is also a creditor of the spouse in bankruptcy so as to be permitted to file a claim and thus share in the value of the community property. The term *creditor* is defined in the Bankruptcy Act to include an "entity that has a community claim"[68] which seems to eliminate "separate" creditors. "Community claims" under the act, however, are those "that arose before the commencement of the case concerning the debtor for which property of the kind specified in section 541(a)(2) . . . is liable."[69] Section 541(a)(2) provides that the bankrupt's estate is comprised of "[a]ll interests of the debtor and the debtor's spouse in community property as of the commencement of the case that is . . . under the sole, equal, or joint management and control of the debtor." In Louisiana, however, community property is by operation of law under the joint management

63. *See* Holtkamp v. Littlefield, 669 F.2d 505 (7th Cir. 1982); Honosky v. Honosky, 6 Bankr. 667 (Bankr. S.D. W. Va. 1980).

64. 712 F.2d 188 (5th Cir. 1983).

65. LA. CIV. CODE art. 2345.

66. 11 U.S.C. § 362(a)(1) (1982).

67. 11 U.S.C. § 501(a) (1982).

68. 11 U.S.C. § 101(9)(C) (1982).

69. 11 U.S.C. § 101(6) (1982).

and control of either spouse, including "the debtor."[70] It follows that the claims of the separate creditors of a nonbankrupt spouse are "community claims," and that the separate creditors are, therefore, "creditors" entitled to allowance of their claims against that property in the bankruptcy of the spouse.

Coowners

In *First National Bank v. Crawford*,[71] the plaintiff bank appealed the dismissal of its suit on a promissory note for failure to amend and join two co-makers on the note previously determined to be necessary parties. The bank had not joined the co-makers because they were in bankruptcy. The promissory note held by the bank was executed by defendant Crawford, her daughter and son-in-law, the Howes, and secured by a mortgage on immovable property owned in indivision by Mrs. Howe and her mother Mrs. Crawford. The Howes operated a dairy farm on land which included the mortgaged tract. The dairy farm was subject to an order for relief under chapter 11 of the Bankruptcy Act containing an injunction and stay order. The second circuit held that the action on the debt, insofar as it related to the Howes and the property securing the note, was precluded by the preemptive exercise of jurisdiction and the stay order of the bankruptcy court. Although the Howes were necessary parties to the suit on the note, the Code of Civil Procedure provides that necessary parties not subject to the jurisdiction of the court need not be joined.[72] The appeal court therefore reversed the trial court's dismissal of the bank's case.

The decison is consistent with the purpose of section 362 of the Bankruptcy Act in that it prevents the creditors, stayed from action against the debtor and his assets in federal court, from obtaining judgment against the debtor's property in state court.

Since in this case, one of the bankrupts was personally liable to the bank, making the bank a "creditor," it could file a claim in the bankruptcy court and reach the mortgaged land there. The outcome is similar to the case of community property discussed above.

Suppose, however, that the bankrupts had undertaken no liability to the bank. The definition of *creditor* includes an "entity that has a claim against the debtor."[73] Since only creditors can file claims, it might appear that the bank has no access to its collateral once the collateral is under the jurisdiction of the bankruptcy court. It is possible that, in such circumstances, a court could find the bank to be a creditor, primarily

70. LA. CIV. CODE art. 2346.
71. 426 So. 2d 1348 (La. App. 2d Cir. 1983).
72. LA. CODE CIV. P. art. 642.
73. 11 U.S.C. § 101(9)(A) (1982).

because the act's definition of claim is both expansive and vague.[74] However, there is another route as well. Anyone who is a "party in interest" may move the bankruptcy court either to compel the trustee to provide "adequate protection" or for relief from the automatic stay.[75] Once the stay is lifted, of course, the bank could proceed to foreclose on the land just as if the bankruptcy had never occurred.

Suppose, however, that after the bank obtains judgment against Mrs. Howe, it can levy on her other assets sufficient to discharge the note. Not having signed on a nonrecourse basis, she is probably fairly called upon to pay. However, the mortgage would likewise be extinguished by that payment. While the co-debtor may have contracted to pay, it is less clear that she intended to provide the other creditors of the Howes a windfall in the bankruptcy—the value of the now unencumbered land being available to pay their claims. Unless Mrs. Crawford, by having paid the bank's claim, can become subrogated to its position and file her own claim as a secured creditor, that outcome is potentially possible.[76] Furthermore, unlike the community property situation, what the coowner of property liable for the debts of a bankrupt loses may also be a loss to the coowner's separate creditors, who have no means of appearing in the bankruptcy themselves.

The cases decided last year, and their possible variants discussed above, illustrate both the questions of statutory technique and bankruptcy policy which must influence the decision on how to disentangle the debtor from others interested in his affairs. First, it is clear that Congress intended the bankruptcy court to partition the interests in any property owned, even in part, by the debtor. The expansive definition of what property belongs in the debtor's estate,[77] and the breadth of operation of the automatic stay provisions in section 362 permit no other conclusion. It should follow that coowners of the property, who may not be, on the date of the bankruptcy petiton, what we would commonly refer to as creditors should be given some standing to appear in the proceedings in which their assets are liquidated and divided. The Bankruptcy Act currently contemplates two possible techniques for such an appearance. The coowner can be deemed a creditor, and perhaps to the extent of his interest in the property even a secured creditor,[78] and the partition of the property and payment to the coowner handled in the administration of the bankrupt's affairs. Alternatively, the coowner can appear in the

74. 11 U.S.C. § 101(4) (1982). Since all rights are deemed claims, the definition is more expansive than the term itself would imply.

75. 11 U.S.C. § 362(d) (1982).

76. 11 U.S.C. § 509 (1982).

77. 11 U.S.C. § 541 (1982).

78. *See* 11 U.S.C. § 506 (1982).

bankruptcy and request "adequate protection"[79] from the trustee, or in lieu thereof, relief from the automatic stay, after which whatever disentangling is needed can take place in state court outside bankruptcy. The grounds for relief from the stay ("cause")[80] or the determination of just what "adequate protection" is, however, will remain fluid concepts until a great deal of case-by-case development occurs with their meaning.

Relief from the stay, of course, means that the problems of coownership must be worked out first with a permission-granting proceeding in bankruptcy, and later with a proceeding somewhere else. Louisiana secured creditors, alone among creditors in the fifty states[81] in their lack of authority to liquidate their collateral in the market without first going through a sheriff's auction, may prefer to have the trustee sell the collateral for them, even for a fee, rather than simply gain permission to conduct a second, expensive, state court foreclosure proceeding afterwards. Coowners, as well, have reason to prefer untangling in bankruptcy, so long as their rights there are adequately protected.

Second, the principle is emerging that simple co-debtors can be treated separately: the bankruptcy of one leaves the other where he contracted to be (or in the case of a tortfeasor, where the law put him). If there are claims among co-debtors, for example, for indemnity or contribution, those claims make the co-debtors "creditors" of the bankrupt. Accordingly, those claims should be handled in the bankruptcy. It would be economical to determine the co-debtor's liability and his claim against the bankrupt in one proceeding. The only justification for not having that proceeding occur in the bankruptcy process is the exhaustion (at the end of the *Marathon*) of the jurisdiction of the bankruptcy courts. Once that jurisdiction is resuscitated, it may be appropriate to take a new look at whether bankruptcy stays ought, indeed, apply to claims against co-debtors.

79. 11 U.S.C. § 362(d) (1982).

80. 11 U.S.C. § 362(d) (1982).

81. All other states, for example, have adopted article 9 of the UCC which, under section 9-503, authorizes creditors to repossess collateral without judicial process.