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The debate over secured credit continues.[1] In recent years scholars have discussed the reasons for secured credit, whether the use of secured credit is efficient, and ultimately whether the law should facilitate or even permit secured transactions.[2] A prominent issue in the debate over secured credit

1. "The debate has smoldered in the academic literature like a coal mine fire for fifteen years and gives no indication of burning out any time soon." Lynn M. LoPucki, *The Unsecured Creditor's Bargain*, 80 VA. L. REV. 1887, 1890 (1994) (footnote omitted) (quoting Steven L. Schwarcz, *The Easy Case for the Priority of Secured Claims in Bankruptcy*, 47 DUKE L.J. 425, 427 n.1 (1997)). The debate has now continued for almost twenty years.

2. *See* Barry E. Adler, *An Equity-Agency Solution to the Bankruptcy-Priority Puzzle*, 22 J. LEGAL STUD. 73, 74 (1993); Douglas G. Baird, *The Importance of Priority*, 82 CORNELL L. REV. 1420, 1420 (1997) [hereinafter Baird, *Importance of Priority*]; *see, e.g.*, Douglas G. Baird, *Security Interests Reconsidered*, 80 VA. L. REV. 2249 (1994); Richard L. Barnes, *The Efficiency Justification for Secured Transactions: Foxes with Soxes and Other Fanciful Stuff*, 42 KAN. L. REV. 13 (1993); Lucian A. Bebchuk & Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy*, 105 YALE L.J. 857 (1996) [hereinafter Bebchuk & Fried, *The Uneasy Case*]; Lucian A. Bebchuk & Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy: Further Thoughts and a Reply to Critics*, 82 CORNELL L. REV. 1279 (1997) [hereinafter Bebchuk & Fried, *Further Thoughts*]; James W. Bowers, *Whither What Hits the Fan?: Murphy's Law, Bankruptcy Theory, and the Elementary Economics of Loss Distribution*, 26 GA. L. REV. 27, 57-68 (1991); F.H. Buckley, *The Bankruptcy Priority Puzzle*, 72 VA. L. REV. 1393 (1986); David G. Carlson, *On the Efficiency of Secured Lending*, 80 VA. L. REV. 2179 (1994); Theodore Eisenberg & Stefan Sundgren, *Is Chapter 11 Too Favorable to Debtors? Evidence from Abroad*, 82 CORNELL L. REV. 1532 (1997); Steven L. Harris & Charles W. Mooney, Jr., *Measuring the Social Costs and Benefits and Identifying the Victims of Subordinating Security Interests in Bankruptcy*, 82 CORNELL L. REV. 1349 (1997) [hereinafter Harris & Mooney, *Measuring the Social Costs*]; Steven L. Harris & Charles W. Mooney, Jr., *A Property-Based Theory of Security Interests: Taking Debtors' Choices Seriously*, 80 VA. L. REV. 2021 (1994) [hereinafter Harris & Mooney, *A Property-Based Theory*]; Thomas H. Jackson & Anthony T. Kronman, *Secured Financing and Priorities Among Creditors*, 88 YALE L.J. 1143 (1979); Alex M. Johnson, Jr., *Adding Another Piece to the Financing Puzzle: The Role of Real Property Secured Debt*, 24 LOY. L.A. L. REV. 317 (1991); Hideki Kanda & Saul Levmore, *Explaining Creditor Priorities*, 80 VA. L. REV. 2103

is the treatment of secured creditors in bankruptcy,[3] with some scholars favoring the status quo, which gives secured creditors priority over unsecured creditors in bankruptcy,[4] and others arguing for a system that places secured and unsecured creditors on a more even playing field.[5]

(1994); Kenneth N. Klee, *Barbarians at the Trough: Riposte in Defense of the Warren Carve-Out Proposal*, 82 CORNELL L. REV. 1466 (1997); Saul Levmore, *Monitors and Freeriders in Commercial and Corporate Settings*, 92 YALE L.J. 49 (1982); Lynn M. LoPucki, *Should the Secured Credit Carve Out Apply Only in Bankruptcy? A Systems/Strategic Analysis*, 82 CORNELL L. REV. 1483 (1997); LoPucki, *supra* note 1; Ronald J. Mann, *Bankruptcy and the Entitlements of the Government: Whose Money Is It Anyway?*, 70 N.Y.U. L. REV. 993 (1995) [hereinafter Mann, *Bankruptcy*]; Ronald J. Mann, *Explaining the Pattern of Secured Credit*, 110 HARV. L. REV. 625 (1997); Ronald J. Mann, *The First Shall be Last: A Contextual Argument for Abandoning Temporal Rules of Lien Priority*, 75 TEX. L. REV. 11 (1996) [hereinafter Mann, *First Shall Be Last*]; Ronald J. Mann, *Secured Credit and Software Financing*, 85 CORNELL L. REV. 134 (1999) [hereinafter Mann, *Software Financing*]; Randal C. Picker, *Security Interests, Misbehavior, and Common Pools*, 59 U. CHI. L. REV. 645 (1992); Schwarcz, *supra* note 1; Alan Schwartz, *The Continuing Puzzle of Secured Debt*, 37 VAND. L. REV. 1051 (1984); Alan Schwartz, *Priority Contracts and Priority in Bankruptcy*, 82 CORNELL L. REV. 1396 (1997); Alan Schwartz, *Security Interests and Bankruptcy Priorities: A Review of Current Theories*, 10 J. LEGAL STUD. 1 (1981); Alan Schwartz, *A Theory of Loan Priorities*, 18 J. LEGAL STUD. 209 (1989); Robert E. Scott, *A Relational Theory of Secured Financing*, 86 COLUM. L. REV. 901 (1986); Robert E. Scott, *The Truth About Secured Financing*, 82 CORNELL L. REV. 1436 (1997); Paul M. Shupack, *Defending Purchase Money Security Interests Under Article 9 of the UCC from Professor Buckley*, 22 IND. L. REV. 777 (1989); Paul M. Shupack, *Solving the Puzzle of Secured Transactions*, 41 RUTGERS L. REV. 1067, 1118 (1989); George G. Triantis, *Secured Debt Under Conditions of Imperfect Information*, 21 J. LEGAL STUD. 225 (1992); Elizabeth Warren, *Making Policy with Imperfect Information: The Article 9 Full Priority Debates*, 82 CORNELL L. REV. 1373 (1997); James J. White, *Efficiency Justifications for Personal Property Security*, 37 VAND. L. REV. 473 (1984); William J. Woodward, Jr., *The Realist and Secured Credit: Grant Gilmore, Common-Law Courts, and the Article 9 Reform Process*, 82 CORNELL L. REV. 1511 (1997).

3. *See* Adler, *supra* note 2, at 74; *see, e.g.*, Bowers, *supra* note 2; Buckley, *supra* note 2, Eisenberg & Sundgren, *supra* note 2; Harris & Mooney, *Measuring the Social Costs*, *supra* note 2; LoPucki, *supra* note 2; Mann, *Bankruptcy*, *supra* note 2; Schwarcz, *supra* note 1; Schwartz, *Priority Contracts*, *supra* note 2; Schwartz, *Security Interests*, *supra* note 2.

4. *See* Baird, *Importance of Priority*, *supra* note 2, at 1435; *see, e.g.*, Harris & Mooney, *Measuring the Social Costs*, *supra* note 2; Schwarcz, *supra* note 1.

5. *See* Bebchuk & Fried, *The Uneasy Case*, *supra* note 2 (proposing a 25% carve-out of secured claims in bankruptcy); David W. Leebron, *Limited Liability, Tort Victims, and Creditors*, 91 COLUM. L. REV. 1565, 1643-49 (1991) (proposing priority for tort claimants); LoPucki, *supra* note 1 (proposing priority for involuntary creditors both in and outside of bankruptcy); Mann, *First Shall Be Last*, *supra* note 2 (proposing changes in the treatment of priorities in construction financing); Mann, *Software Financing*, *supra* note 2 (proposing changes in the treatment of software financing); Robert K. Rasmussen, *An Essay on Optimal Bankruptcy Rules and Social Justice*, 1994 U. ILL. L. REV. 1, 31-34 (proposing priority for tort claimants); Robert K. Rasmussen & David A. Skeel, Jr., *The Economic Analysis of Corporate Bankruptcy Law*, 3 AM. BANKR. INST. L. REV. 85, 86 (1995) (proposing priority for tort claimants); Memorandum from Elizabeth Warren, Leo Gottlieb Professor of Law, Harvard Law School, to the Council of the American Law Institute 1-2 (Apr. 25, 1996) [hereinafter Warren Memorandum to the ALI] (on file with author) (proposing a 20% carve-out of a debtor's assets applicable both in and outside of bankruptcy to commercial

An issue mostly left out of the debate is the constitutionality of major modifications to the treatment of secured creditors in bankruptcy. At least some scholars feel that the Takings Clause does not limit prospective bankruptcy legislation. I disagree. The Takings Clause does limit the power of Congress to impair the rights of secured creditors in bankruptcy, even prospectively, and my purpose in this Article is to explain why.

Scholars proposing changes to the treatment of secured creditors in bankruptcy have relied on an understanding of the Takings Clause that over time has proven to be incorrect. More than fifteen years ago, Professor James Steven Rogers published an article in the *Harvard Law Review* on the relationship between the Fifth Amendment and the Bankruptcy Clause.[6] In his article Professor Rogers focused on the impairment of the rights of secured creditors in reorganization proceedings in exploring the extent to which the Fifth Amendment limits the bankruptcy power.[7] He first concluded that the Fifth Amendment does not impose any limitations upon the power of Congress to enact purely prospective legislation impairing security interests, going so far as to suggest that "no takings clause issue [could] ever be presented by a truly prospective statute."[8] His reasoning was that property rights of secured creditors are redefined by changes in bankruptcy law, and he also assumed that the rights of secured creditors are no different from the rights of unsecured creditors.[9] He ultimately concluded that the Bankruptcy Clause rather than the Fifth Amendment limits Congressional power with respect to prospective bankruptcy legislation, and he criticized the Supreme Court's application of Fifth Amendment principles even to retroactive legislation.[10]

Since Professor Rogers published his article, the Supreme Court has made defining changes in the landscape of takings jurisprudence[11] and has

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loans secured by Article 9 security interests); Letter from Jay L. Westbrook, Benno C. Schmidt Chair of Business Law, University of Texas School of Law, to the Council of the American Law Institute 5-6 (Sept. 4, 1996) (on file with author) (proposing a carve-out only in bankruptcy).

6. James Steven Rogers, *The Impairment of Secured Creditors' Rights in Reorganization: A Study of the Relationship Between the Fifth Amendment and the Bankruptcy Clause*, 96 HARV. L. REV. 973, 973 (1983).

7. *See id.* at 986.

8. *Id.* at 987 n.59.

9. *See id.* at 987-89.

10. *See id.* at 1031.

11. The Supreme Court has decided numerous takings cases since its 1982-83 term. *See* Eastern Enters. v. Apfel, 118 S. Ct. 2131, 2137 (1998); *see, e.g.*, Phillips v. Washington Legal Found., 118 S. Ct. 1925 (1998); Suitum v. Tahoe Reg'l Planning Agency, 520 U.S. 725 (1997); Babbitt v. Youpee, 519 U.S. 234 (1997); Dolan v. City of Tigard, 512 U.S. 374 (1994); Concrete Pipe & Prods., Inc. v. Construction Laborers Pension Trust, 508 U.S. 602 (1993); Lucas v. South Carolina Coastal Council, 505 U.S. 1003 (1992); Yee v. City of Escondido, 503 U.S. 519 (1992); Nollan v. California Coastal Comm'n, 483 U.S. 825 (1987); Hodel v. Irving, 481 U.S. 704 (1987); Keystone Bituminous Coal Ass'n v. DeBenedictis, 480 U.S. 470 (1987); Connolly v. Pension

implicitly rejected Professor Rogers' approach to defining the scope of property rights.[12] Yet discussion of the takings issue in the context of the secured credit debate has not reflected these changes in takings jurisprudence. Although a number of scholars published articles addressing Fifth Amendment limitations on bankruptcy law before Professor Rogers,[13] none have explored the issue since.[14] Prominent scholars have accepted his conclusions about prospective bankruptcy legislation without challenge.[15] More importantly, scholars proposing changes to the treatment of secured creditors in bankruptcy have assumed the constitutionality of their

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Benefit Guar. Corp., 475 U.S. 211 (1986); Ruckelshaus v. Monsanto Co., 467 U.S. 986 (1984).

12. *See infra* Part III.C. Even before his article, the Court had rejected his assertion that the rights of secured creditors are no different from the rights of unsecured creditors. *See infra* notes 172-74 and accompanying text.

13. *See* Vern Countryman, *Real Estate Liens in Business Rehabilitation Cases*, 50 AM. BANKR. L.J. 303, 334-39 (1976); Vern Countryman, *Treatment of Secured Claims in Chapter Cases*, 82 COM. L.J. 349, 355-60 (1977); *see, e.g.*, Patrick A. Murphy, *Restraint and Reimbursement: The Secured Creditor in Reorganization and Arrangement Proceedings*, 30 BUS. LAW. 15 (1974); Patrick A. Murphy, *Use of Collateral in Business Rehabilitations: A Suggested Redrafting of Section 7-203 of the Bankruptcy Reform Act*, 63 CAL. L. REV. 1483 (1975); Robert J. Rosenberg, *Beyond* Yale Express: *Corporate Reorganization and the Secured Creditor's Rights of Reclamation*, 123 U. PA. L. REV. 509 (1975); George C. Webster II, *Collateral Control Decisions in Chapter Cases—Clear Rules v. Judicial Discretion*, 51 AM. BANKR. L.J. 197 (1977); Note, *Constitutional Limitations on the Bankruptcy Power: Chapter XII Real Property Arrangements*, 52 N.Y.U. L. REV. 362 (1977); Note, *Conrail and Liquidation Value: Creditors' and Stockholders' Entitlement in the Regional Rail Reorganization*, 85 YALE L.J. 371 (1976); Note, *Takings and the Public Interest in Railroad Reorganization*, 82 YALE L.J. 1004 (1973); Comment, *The Secured Creditor's Right to Full Liquidation Value in Corporate Reorganization*, 42 U. CHI. L. REV. 510 (1975).

14. One article discusses relevant cases and commentary, including Professor Rogers' article, in the context of continuing legal education for practitioners. *See* Frank R. Kennedy, *Bankruptcy and the Constitution*, *in* BLESSINGS OF LIBERTY: THE CONSTITUTION AND THE PRACTICE OF LAW 131, 151-59 (American Law Inst.–American Bar Ass'n Comm. on Continuing Professional Educ. ed., 1988). Another article discusses constitutional limitations on the bankruptcy power, but excludes the Takings Clause issue. *See* Thomas E. Plank, *The Constitutional Limits of Bankruptcy*, 63 TENN. L. REV. 487, 490 n.13 (1996). A few articles discuss the takings issue only in the context of a particular provision of, or issue in, bankruptcy. *See, e.g.*, John D. Ayer, *Rethinking Absolute Priority After* Ahlers, 87 MICH. L. REV. 963, 979-84 (1989); Ralph R. Mabey & Jamie A. Gavrin, *Constitutional Limitations on the Discharge of Future Claims in Bankruptcy*, 44 S.C. L. REV. 745, 762-71 (1993).

15. *See, e.g.*, Douglas G. Baird & Thomas H. Jackson, *Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy*, 51 U. CHI. L. REV. 97, 100 (1984); David G. Carlson, *Postpetition Interest Under the Bankruptcy Code*, 43 U. MIAMI L. REV. 577, 585-86 (1989); Theodore Eisenberg, *The Undersecured Creditor in Reorganizations and the Nature of Security*, 38 VAND. L. REV. 931, 952 n.69 (1985); Thomas H. Jackson, *Avoiding Powers in Bankruptcy*, 36 STAN. L. REV. 725, 736 n.29 (1984); Steven L. Schwarcz, *Protecting Rights, Preventing Windfalls: A Model for Harmonizing State and Federal Laws on Floating Liens*, 75 N.C. L. REV. 403, 405 n.4 (1997); Jay L. Westbrook, *A Functional Analysis of Executory Contracts*, 74 MINN. L. REV. 227, 262 n.160 (1989).

proposals based on his reasoning.[16] In addition, courts have continued to struggle in applying the takings doctrine in the bankruptcy context. Some courts have adopted Professor Rogers' reasoning with respect to prospective bankruptcy legislation,[17] while others have continued to rely on cases and concepts he criticized.[18] The time has come, therefore, to revisit the issue of takings in bankruptcy.

Like Professor Rogers, I will focus primarily on the impairment of the rights of secured creditors,[19] and I will ultimately consider the extent to which the bankruptcy power is limited by the Takings Clause.[20] Professor Rogers was concerned with the rights of secured creditors because of attention at that time to the problem of interim restraints on their rights in reorganization proceedings.[21] I am concerned with the rights of secured creditors because of the secured credit debate. I will focus on the rights of secured creditors with security interests in both real and personal property.[22] In addition, I will consider the effect of bankruptcy on other

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16. *See* Bebchuk & Fried, *The Uneasy Case*, *supra* note 2, at 932; LoPucki, *supra* note 1, at 1952-54; *see also* Steve Knippenberg, *The Unsecured Creditor's Bargain: An Essay in Reply, Reprisal, or Support?*, 80 VA. L. REV. 1967, 1974 (1994) (citing Professor Rogers in support of Professor LoPucki's proposal).

17. *See* Patriot Portfolio, LLC v. Weinstein (*In re* Weinstein), 164 F.3d 677, 686 (1st Cir. 1999) ("Because Patriot's property rights in the lien are circumscribed by the debtor's ability under the Code to avoid the lien, prospective application of § 522(f) does not constitute a 'taking' of Patriot's property interest . . . ."); Bruin Portfolio, LLC v. Leicht (*In re* Leicht), 222 B.R. 670, 683 n.19 (B.A.P. 1st Cir. 1998) ("If his property rights are defined by reference to existing law, obviously no taking has occurred."). The results in these cases are probably correct, but the reasoning is faulty. *See infra* notes 255-57 and accompanying text.

18. *See* Travelers Ins. Co. v. Burlington, 878 F.2d 354, 359 (11th Cir. 1989) ("It is undisputed that the takings clause of the fifth amendment protects certain of the rights of secured creditors.") (citing Louisville Joint Stock Land Bank v. Radford, 295 U.S. 555 (1935)); United Sav. Ass'n v. Timbers of Inwood Forest Assocs. (*In re* Timbers of Inwood Forest Assocs.), 793 F.2d 1380, 1390 n.14 (1986) ("[T]he Fifth Amendment requires only that the value of the secured position of a creditor be maintained during the stay.") (citing Wright v. Union Central Life Ins. Co., 311 U.S. 273, 278 (1940)).

19. *See* Rogers, *supra* note 6, at 974.

20. Professor Rogers was concerned with the Contracts Clause and the Due Process Clause as well. *See id.* at 974. In this Article, I focus only on the Takings Clause.

21. *See id.* Congress had enacted the Bankruptcy Code, making changes to the reorganization proceedings, only five years earlier. *See infra* note 28 and accompanying text. Also, commentators had recently been concerned with the treatment of secured creditors in reorganizations. *See supra* note 13. In addition, an important developing issue was whether undersecured creditors were entitled to interest on their claims. *See infra* note 208 and accompanying text.

22. I will use the general term "security interest" in this Article to refer to the interest of a secured creditor in either real or personal property created by agreement with the debtor. The Bankruptcy Code defines security interest as "a lien created by an agreement." 11 U.S.C. § 101(51) (1994).

I will use the term "property" to refer to the entire bundle of rights that an owner may have with respect to a tract of land or an item of personal property, whether tangible or intangible. The term property interests, such as the interest of the tenant of a bankrupt landlord, in ultimately addressing the bigger issue of the extent to which the Takings Clause limits the power of Congress to revise bankruptcy law.

Unlike Professor Rogers, I believe that the Takings Clause is a vital consideration in determining the treatment of secured creditors in bankruptcy. This Article will explain why the Takings Clause is relevant and why scholars engaged in the debate over secured credit must consider the constitutionality of their proposals in light of the takings issue. In Part I of the Article, I explore the ways in which current bankruptcy law provides protection and gives deference to property rights. I also discuss certain proposals that would reduce the protection given to secured parties. Part II provides an overview of takings law and discusses some of the cases in which the Supreme Court has addressed takings issues in the context of bankruptcy.

In Part III of the Article, I dispute the validity of certain assumptions that have been used by courts and scholars as the basis for dismissing the bankruptcy takings problem. Most of these assumptions are based on conclusions reached by Professor Rogers in his article. However, some of Professor Rogers' conclusions were incorrect even at the time of his article. Some of his conclusions were normative and, therefore, should not be the basis for assumptions about the constitutionality of proposals made in the secured credit debate. Finally, some of his reasoning has proven incorrect over time as the Supreme Court has expanded upon the meaning of the Takings Clause. Because these assumptions about the bankruptcy takings problem are faulty, the problem must be reevaluated.

In Part IV of this Article, I discuss the application of current takings doctrine to present bankruptcy law and to proposals made in the context of the secured credit debate. First, I look at the problem of delay for secured creditors and at lien avoidance provisions under current bankruptcy law. I conclude that the lien avoidance provisions are constitutional and that only the most extraordinary case of delay for a secured creditor could constitute a taking. Next, I consider the assertion made by several scholars, based on Professor Rogers' reasoning, that Congress could completely invalidate security interests in bankruptcy on a prospective basis.[23] I

"property" may therefore also refer to the land or thing itself, in the less technical use of the word. I will use the terms "property right," "property interest" and "interest in property" to refer to some right or bundle of rights that constitutes less than the full bundle of sticks. *See* Thomas E. Plank, *The Outer Boundaries of the Bankruptcy Estate*, 47 EMORY L.J. 1193, 1200-13 (1998) (giving a more detailed discussion of the use of these terms in the context of bankruptcy). *See generally* JAN G. LAITOS, LAW OF PROPERTY RIGHTS PROTECTION: LIMITATIONS ON GOVERNMENTAL POWERS § 5.01 (1999) (discussing three meanings of the term "property"—the thing itself, the legal rights in the thing, and the ownership of the thing).

23. *See infra* Part IV.B.

conclude that this assertion is incorrect. Scholars are currently debating the merits of proposals that would drastically reduce the rights of secured creditors in bankruptcy without considering the takings issue at all.[24] Some of these proposals may be unconstitutional. At minimum, they raise significant and complex issues under the Takings Clause, many of which are so fact-dependant that they will be a source of uncertainty for years to come.

I. BANKRUPTCY LAW

The Constitution gives Congress the power "[t]o establish . . . uniform Laws on the subject of Bankruptcies throughout the United States."[25] There was no lasting federal bankruptcy system in place until 1898, when Congress enacted the Bankruptcy Act of 1898.[26] The Act remained in effect for eighty years with substantial changes made during the Depression.[27] More recently, bankruptcy law is embodied in the Bankruptcy Code, which was enacted in 1978[28] and was amended in 1984,[29] 1986,[30] and 1994.[31]

Early bankruptcy laws were solely for the benefit of creditors,[32] but modern bankruptcy law provides protection for debtors as well. The dual

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24. A large portion of my discussion of takings in the bankruptcy context is based not on existing bankruptcy law but on changes to bankruptcy law that have been proposed or discussed by various scholars, primarily in the context of the secured credit debate. Many of the articles contain a paragraph dismissing the takings problem. Frequently, this dismissal is based on Professor Rogers' argument that prospective legislation defines the property rights of a secured creditor. *See* Rogers, *supra* note 6, at 974. In other articles, the basis is that a security interest should not be treated as an interest in property.

25. U.S. CONST. art. I, § 8.

26. Ch. 541, 30 Stat. 544 (repealed 1978). Congress had enacted short-lived bankruptcy statutes in the 1800s. *See* Bankruptcy Act of 1800, ch. 19, 2 Stat. 19, *repealed by* Act of Dec. 19, 1803, ch. 6, 2 Stat. 248; Bankruptcy Act of 1841, ch. 9, 5 Stat. 440, *repealed by* Act of Mar. 3, 1843, ch. 82, 5 Stat. 614; Bankruptcy Act of 1867, ch. 176, 14 Stat. 517, *repealed by* Act of June 7, 1878, ch. 160, 20 Stat. 99. Many states had bankruptcy and insolvency statutes that filled the void during the periods in between; *see* Charles Jordan Tabb, *The History of the Bankruptcy Laws in the United States*, 3 AM. BANKR. INST. L. REV. 5, 12-13 (1995).

27. Amendments during the Depression included the Frazier-Lemke Act and the Chandler Act. *See* Frazier-Lemke Act, ch. 869, 48 Stat. 1289 (1934), discussed below in Part II.B.; Chandler Act, ch. 575, 52 Stat. 840 (1938), which was the most substantial and comprehensive amendment. *See* Tabb, *supra* note 26, at 28-29.

28. *See* Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 (codified at 11 U.S.C.).

29. *See* Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, 98 Stat. 333.

30. *See* Bankruptcy Judges, United States Trustees, and Family Farmer Bankruptcy Act of 1986, Pub. L. No. 99-554, 100 Stat. 3088.

31. *See* Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, 108 Stat. 4106.

32. *See* Tabb, *supra* note 26, at 14.

policies of modern bankruptcy law are the fresh start policy, discharging individual debtors from most debts in exchange for surrendering either nonexempt assets or a portion of future income, and the policy protecting creditors from each other by providing a mandatory forum for the fairest distribution of available assets to creditors.[33] When bankruptcy law, in furtherance of these or other policies, prevents creditors from taking actions otherwise available to them, contract and property rights are impaired. The question addressed in this Article is the extent to which the Constitution permits the impairment of property rights, especially the rights of secured creditors.

A. *Protection of Property Interests Under Current Bankruptcy Law*

Legislative history of the Bankruptcy Code indicates that the drafters of the Code considered the Fifth Amendment to be a limitation upon the impairment of property rights in bankruptcy,[34] and current bankruptcy law does give great deference to property rights.[35] When a debtor files a bankruptcy petition, a bankruptcy estate is created and includes "all legal or equitable interests of the debtor in property" at the time of filing.[36] There may be items of property in which both the debtor and another party own interests. For example, the debtor may be a landlord of property in which tenants have interests, may have only the rights of a tenant in a third party landlord's property, or may own property in co-tenancy with other parties. In addition, the debtor may have granted security interests in property to secured parties. I will first examine the rights of secured creditors in bankruptcy. Then I will discuss some examples of the treatment of other property rights in bankruptcy.

A basic understanding of the workings of bankruptcy is helpful in order to understand how the Bankruptcy Code protects the property rights of secured creditors. Most debtors entering voluntary bankruptcy have two choices: liquidation under Chapter 7 of the Bankruptcy Code or

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33. *See* THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW 4 (1986); TERESA A. SULLIVAN, ELIZABETH WARREN & JAY WESTBROOK, AS WE FORGIVE OUR DEBTORS: BANKRUPTCY AND CONSUMER CREDIT IN AMERICA 20 (1989). Some scholars have argued that bankruptcy law should also be used to promote other worthwhile social policies. *See* Elizabeth Warren, *Bankruptcy Policymaking in an Imperfect World*, 92 MICH. L. REV. 336, 344 (1993).

34. Both House and Senate Reports indicate that the reason for the adequate protection requirement was based on the constitutional requirements under the Fifth Amendment. *See* S. REP. NO. 989, 95th Cong., 2d Sess. 49 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787; H.R. REP. NO. 595, 95th Cong., 1st Sess. 339 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6295.

35. This deference "is based as much on policy grounds as on constitutional grounds." H.R. REP. NO. 595, at 339.

36. 11 U.S.C. § 541(a) (1994); *see also* MICHAEL J. HERBERT, PROPERTY INTERESTS IN BANKRUPTCY § 1.1 (1996); Plank, *supra* note 22, at 1194.

reorganization under Chapter 11 for businesses or under Chapter 13 for most individuals. In a Chapter 7 liquidation, the debtor's non-exempt assets are liquidated, and proceeds are distributed to creditors. In exchange for giving up non-exempt assets, most of an individual debtor's debts are discharged, and the debtor is given a fresh start free from the discharged debts.[37] In the Chapter 7 liquidation of an entity, there is no discharge,[38] but the entity typically ceases its operations upon liquidation.[39] In a Chapter 7 liquidation, unsecured creditors rarely receive the full amount they are due and frequently receive nothing.[40] Secured creditors, on the other hand, are generally entitled to receive the full amount of their secured claims. The property securing a claim may be sold by the trustee subject to the security interest, or it may be sold free and clear of the security interest with proceeds being distributed to the secured creditor.[41] If the bankruptcy estate has no equity in the property, the trustee may abandon the property to the secured creditor.[42] An individual debtor may redeem certain types of property by paying the secured creditor an amount equal to the secured claim.[43] In any event, the secured creditor should receive the full value of the secured claim within a relatively short period of time.

The goal of a Chapter 11 or Chapter 13 reorganization is to eventually confirm a plan of repayment that will provide more to creditors than a liquidation. Once again, however, unsecured creditors tend to receive a very small percentage of the amount they are due.[44] In theory, secured creditors are entitled to receive as much under a reorganization plan as they would in a Chapter 7 liquidation.[45] The primary difference between liquidation and reorganization for secured creditors is the delay factor. Particularly in a Chapter 11 filing, a significant period of time can elapse after the bankruptcy filing and before a plan is confirmed.[46] During this

37. *See* 11 U.S.C. § 727.

38. *See id.* at § 727(a)(1).

39. *See* DOUGLAS G. BAIRD, THE ELEMENTS OF BANKRUPTCY 14 (1992).

40. *See* James W. Bowers, *Groping and Coping in the Shadow of Murphy's Law: Bankruptcy Theory and the Elementary Economics of Failure*, 88 MICH. L. REV. 2097, 2098 n.2 (1990); Michael J. Herbert & Domenic E. Pacitti, *Down and Out in Richmond, Virginia: The Distribution of Assets in Chapter 7 Bankruptcy Proceedings Closed During 1984-87*, 22 U. RICH. L. REV. 303, 311 (1988).

41. *See* 11 U.S.C. § 363(b), (f).

42. *See id.* § 554.

43. *See id.* § 722; *see also* Dewsnup v. Timm, 502 U.S. 410 (1992) (prohibiting "lien stripping").

44. *See* Lynn M. LoPucki, *The Debtor in Full Control—Systems Failure Under Chapter 11 of the Bankruptcy Code*, Parts 1 & 2, 57 AM. BANKR. L.J. 99, 103-26, 247-71 (1983).

45. *See* 11 U.S.C. § 1325(a)(4).

46. A Chapter 11 proceeding typically lasts 18 months or more. *See* Douglas G. Baird, *The Reorganization of Closely Held Firms and the "Opt Out" Problem*, 72 WASH U. L.Q. 913, 916 (1994); Bebchuk & Fried, *The Uneasy Case*, *supra* note 2, at 911; Lynn M. LoPucki, *The Trouble*

time a secured creditor is stayed from taking any action to collect the debt or to realize upon collateral.[47] The stay creates a potential for loss to a secured creditor because the value of collateral can decline over time and because of lost opportunity cost. These issues are addressed in the Bankruptcy Code with a concept called "adequate protection."[48]

Adequate protection gives secured creditors protection against the value of their security declining during the pendancy of a bankruptcy proceeding. Another component of loss for the secured creditor during this time is lost opportunity cost, because the creditor is stayed from foreclosing on the collateral. During the pendancy of a bankruptcy proceeding, oversecured creditors, those with claims that are less than the value of their collateral, are entitled to accrue interest.[49] If an adequate equity cushion exists, then the secured creditor is deemed adequately protected. Otherwise, the secured creditor may be entitled to periodic payments. Undersecured creditors, those with claims that exceed the value of their collateral, are not entitled to lost opportunity cost.[50] Except for lost opportunity cost to undersecured creditors, the Code, at least in theory, protects secured creditors' right to the value of their collateral.

The Bankruptcy Code also gives deference to property rights of third parties other than those of secured creditors. For example, when a landlord is in bankruptcy, the trustee or debtor in possession has the option to reject a lease, but the tenant may retain rights of possession and use of the property for the remainder of the lease term, including any renewal or extension.[51] Therefore, although contractual rights under the lease may be rejected, a tenant's property rights are preserved.

Another example of deference to property rights under the Bankruptcy Code is the treatment of co-ownership interests of third parties in property of the debtor. Property of the estate can be sold free and clear of co-ownership interests only if partition in kind is impracticable, sale of the estate's undivided interest would realize substantially less for the estate,

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with Chapter 11, 1993 WIS. L. REV. 729, 739-45.

47. *See* 11 U.S.C. § 362(a).

48. Adequate protection may be required in connection with the automatic stay of § 362, the use, sale or lease or property under § 323, or the court's authorization of a junior lien under § 364. 11 U.S.C. § 323; 11 U.S.C. § 362; 11 U.S.C. § 364. Adequate protection may be provided by requiring cash payments to the party, by providing for additional or replacement liens, or by "granting such other relief . . . as will result in the realization by such entity of the indubitable equivalent of [the property interest]." 11 U.S.C. § 361(3). Although the concept of adequate protection is applicable to any interest of a third party in property of the estate, it is particularly applicable with respect to security interests.

49. *See* 11 U.S.C. § 506(b).

50. *See infra* notes 201-05 and accompanying text.

51. *See* 11 U.S.C. § 365(h)(1)(A)(ii).

and the benefit to the estate outweighs the detriment to the co-owner.[52] Most courts addressing the constitutionality of this provision have upheld it against a Fifth Amendment challenge on the basis that the taking is for a public purpose and compensation is paid to the co-owner.[53] Therefore, the Bankruptcy Code tends to respect the state law rights of property owners.

B. *Proposals for Changing the Treatment of Secured Creditors*

Although current bankruptcy law gives great deference to property rights of secured creditors, critics of secured credit would reduce or eliminate the priority of secured creditors in bankruptcy. For example, Professors Bebchuk and Fried have proposed that secured creditors receive only 75% of the amount of their secured claims, treating the remainder of each claim as unsecured and reserving the remaining collateral value for payment of unsecured claims.[54] As an alternative, they proposed that nonadjusting creditors, those who cannot adjust the size of their claims to reflect the existence of secured credit,[55] "not be subordinated to secured claims with respect to which they were nonadjusting."[56] Other scholars have proposed giving tort claimants priority over secured creditors in bankruptcy.[57]

Other proposals do not address bankruptcy specifically, but would change the priority of secured creditors both in and out of bankruptcy. Professor Leebron has proposed priority for tort claimants over secured creditors under both bankruptcy and commercial law,[58] and Professor LoPucki has proposed giving other involuntary creditors priority as well.[59]

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52. *See* 11 U.S.C. § 363(h).

53. *See* Coan v. Bernier (*In re* Bernier), 176 B.R. 976, 990 (Bankr. D. Conn. 1995); *In re* Tsunis, 39 B.R. 977, 980 (Bankr. E.D.N.Y. 1983), *aff'd* 733 F.2d 27 (2d Cir. 1984). *But see* Community Nat'l Bank & Trust Co. v. Persky (*In re* Persky), 134 B.R. 81, 100 (Bankr. E.D.N.Y. 1991). Unfortunately, not all state and federal schemes similarly respect co-owners' property rights. *See generally* Mary B. Spector, *Crossing the Threshold: Examining the Abatement of Public Nuisances Within the Home*, 31 CONN. L. REV. 547 (1999) (criticizing state nuisance abatement and federal forfeiture schemes that fail to take into account interests of co-owners).

54. *See* Bebchuk & Fried, *The Uneasy Case*, *supra* note 2, at 908-09.

55. *See id.* at 882. Nonadjusting creditors include private involuntary creditors such as tort claimants, governmental entities with tax and regulatory claims, voluntary creditors with claims too small to warrant adjusting for secured credit, and prior voluntary creditors. *See id.* at 882-88.

56. *Id.* at 905.

57. *See* Rasmussen, *supra* note 5, at 31-34; Rasmussen & Skeel, *supra* note 5, at 87.

58. *See* Leebron, *supra* note 5, at 1643-49.

59. *See* LoPucki, *supra* note 1, at 1963. Involuntary creditors would have priority over unsecured voluntary creditors as well. *See id.* Tort claimants are the most obvious example of involuntary creditors, but the category may also include former spouses and children with unpaid

Professor Warren would permit unsecured creditors to reach 20% of the value of a debtor's assets.[60] Unsecured creditors would first be required to execute on unencumbered assets, but could reach assets subject to security interests to the extent that unencumbered assets were not available.[61] Professor Warren's proposal would apply only to Article 9 security interests and only to commercial loans.[62]

Scholars proposing to modify the treatment of secured creditors have focused on public policy issues in commercial law and bankruptcy law. They have for the most part avoided discussing constitutional issues raised by their proposals.

II. TAKINGS LAW

Takings law has been described as a "muddle."[63] Some scholars have attempted to unmuddle takings law,[64] while others have acknowledged that there can be no "coherent master rule" in takings.[65] My purpose in this article is not to reconceptualize takings law but to try to fit the bankruptcy

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support claims, governmental agencies, educational lenders, health care providers, taxing authorities, landlords, and utility companies. *Id.* at 1896 (citing SULLIVAN ET AL., *supra* note 33, at 18, 294).

60. *See* Warren Memorandum to the ALI, *supra* note 5, at 1.

61. *See id.*

62. *See id.*

63. *See* Carol M. Rose, Mahon *Reconstructed: Why the Takings Issue Is Still a Muddle*, 57 S. CAL. L. REV. 561, 561 (1984). *See also* Daniel L. Mandelker, *New Property Rights Under the Taking Clause*, 81 MARQ. L. REV. 9, 11, 16 (1997) (discussing the "segmentation muddle"); Jeremy Paul, *The Hidden Structure of Takings Law*, 64 S. CAL. L. REV. 1393, 1524 (1991) ("chaos" in takings law); Jed Rubenfeld, *Usings*, 102 YALE L. J. 1077, 1078 (1993) (takings law is "engulfed in confusion"). Professors Heller and Krier have described Supreme Court takings decisions since *Pennsylvania Coal* as follows:

> Supreme Court decisions over the last three-quarters of a century have obscured and bifurcated the nuisance exception to regulatory takings; have waffled on the question of conceptual severance; have distinguished inconsistently between permanent and temporary takings; have suggested that what is not just compensation actually is just compensation, if only regulators are crafty; have made little of large losses, unless they are entire, and much of small ones, even when they are zero; have become confused about what "private property" is for purposes of the Takings Clause; have, in short, turned the words of the Takings Clause into a cryptogram that only the Justices in a given case are able to decipher (and seldom do all of them agree).

Michael A. Heller & James E. Krier, *Deterrence and Distribution in the Law of Takings*, 112 HARV. L. REV. 997, 1023-24 (1999) (footnotes omitted).

64. *See, e.g.*, Heller & Krier, *supra* note 63, at 1024.

65. *See* Margaret Jane Radin, *Diagnosing the Takings Problem*, *in* REINTERPRETING PROPERTY 146, 165 (1993).

takings problem into the current legal framework of takings jurisprudence in the most rational way. In order to evaluate the bankruptcy takings problem, however, I must elaborate on some of the elements of the existing formula. I will begin with a discussion of the principal takings cases handed down by the Supreme Court. Then I will discuss the bankruptcy takings cases.

A. *A Primer on Takings Law*

The Fifth Amendment prohibits takings of private property for public use without just compensation.[66] Therefore, the Constitution requires that governmental takings of private property be for the benefit of the public[67] and that just compensation be paid. Until the 1920s, the Takings Clause was applied only to invalidate the appropriation of property or physical ouster by government without compensation.[68] Regulation of property was treated separately under the police power. Courts found that if the government was acting within the scope of its police power in regulating, no taking could occur.[69] In 1922, Justice Holmes, writing the opinion in *Pennsylvania Coal Co. v. Mahon*,[70] first applied the Takings Clause to regulation of property, stating, "if regulation goes too far it will be recognized as a taking."[71] The Court has found that the purpose of the Takings Clause is "to prevent the government 'from forcing some people alone to bear public burdens which, in all fairness and justice, should be borne by the public as a whole.'"[72]

Since its holding in *Pennsylvania Coal*, the Court has refined its jurisprudence on regulatory takings. In *Penn Central Transportation Co. v. New York City*,[73] the Court enunciated three factors that have particular significance in determining when a regulatory taking has occurred: (1) "the character of the governmental action," (2) "[t]he economic impact of the

66. "[N]or shall private property be taken for public use, without just compensation." U.S. CONST. amend. V. The Fifth Amendment is made applicable to the states through the Fourteenth Amendment. *See* Chicago, Burlington & Quincy R.R. v. Chicago, 166 U.S. 226, 238-41 (1897).

67. The Supreme Court has construed the public use requirement broadly as a requirement of public benefit. *See* Hawaii Hous. Auth. v. Midkiff, 467 U.S. 229, 241 (1984).

68. *See* Lucas v. South Carolina Coastal Council, 505 U.S. 1003, 1014 (1992).

69. *See, e.g.*, Hadacheck v. Sebastian, 239 U.S. 394, 394-95 (1915); Mugler v. Kansas, 123 U.S. 623, 623-24 (1887).

70. 260 U.S. 393 (1922).

71. *Id.* at 415. *But cf.* Robert Brauneis, *"The Foundation of Our 'Regulatory Takings' Jurisprudence": The Myth and Meaning of Justice Holmes' Opinion in* Pennsylvania Coal Co. v. Mahon, 106 YALE L.J. 613 (1996) (arguing that *Pennsylvania Coal* was decided on the basis of the due process clause rather than the takings clause).

72. Eastern Enters. v. Apfel, 118 S. Ct. 2131, 2146 (1998) (quoting Armstrong v. United States, 364 U.S. 40, 49 (1960)).

73. 438 U.S. 104 (1978).

regulation," and (3) the extent to which it interferes with reasonable investment-backed expectations.[74] In *Lucas v. South Carolina Coastal Council*,[75] the Court set forth two types of categorical takings that did not require a court to consider the ad hoc test of *Penn Central*.[76] The two categorical takings are regulations that compel a physical invasion of property and regulations that deny an owner all economically beneficial use of property.[77] However, an exception exists where denial of all economically beneficial use comes from a limitation that "background principles of the State's law of property and nuisance already place upon land ownership."[78] Thus, the Takings Clause does not require compensation if the limitation is a part of the owner's title.[79]

The Supreme Court has also held that a taking will occur if land use regulation "does not substantially advance [a] legitimate [governmental] interest[]."[80] In *Nollan v. California Coastal Commission*,[81] and *Dolan v. City of Tigard*,[82] the Court made clear that at least in the context of exactions, this test is an intermediate level scrutiny test. Commentators have discussed whether the substantial relationship requirement comes from the Takings Clause or the Due Process Clause[83] and whether the heightened scrutiny is applicable in all takings cases or only in exactions cases.[84] These issues are not relevant in this Article because I will assume that bankruptcy legislation enacted pursuant to the Bankruptcy Clause would meet either test.[85]

In applying the takings formula, a court must first determine if there is a protected property interest at stake.[86] If so, the court then determines

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74. *Id.* at 124; *see Eastern*, 118 S. Ct. at 2146; Hodel v. Irving, 481 U.S. 704, 714 (1987) (citing Kaiser Aetna v. United States, 444 U.S. 164, 175 (1979)).

75. 505 U.S. 1003 (1992).

76. *See id.* at 1015.

77. *See id.*

78. *Id.* at 1029.

79. *See id.* at 1030.

80. Agins v. Tiburon, 447 U.S. 255, 260 (1980); *see* Lucas, 505 U.S. at 1016.

81. 483 U.S. 825 (1987).

82. 512 U.S. 374 (1994).

83. *See* Lawrence Berger, *Public Use, Substantive Due Process and Takings—An Integration*, 74 NEB. L. REV. 843, 862-71 (1995); Thomas E. Roberts et al., *Land-Use Litigation: Doctrinal Confusion Under the Fifth and Fourteenth Amendments*, 28 URB. LAW. 765, 766 (1996).

84. *See* Berger, *supra* note 83, at 869; Matthew J. Cholewa & Helen L. Edmonds, *Federalism and Land Use After* Dolan: *Has the Supreme Court Taken Takings from the States?*, 28 URB. LAW. 401, 419-23 (1996).

85. *See infra* note 145.

86. *See, e.g.*, Phillips v. Washington Legal Found., 118 S. Ct. 1925, 1928 (1998); M & J Coal Co. v. United States, 47 F.3d 1148, 1154 (Fed. Cir. 1995); *see also* LAITOS, *supra* note 22, at III-3 ("The threshold question should therefore not be whether the government has in some way violated the Constitution, but whether the government action has affected an interest that is recognized as

whether a categorical taking under *Lucas* exists. Finally, if there is no categorical taking, the court must apply the ad hoc test that originated in *Penn Central*. Essentially, the court must determine whether "'justice and fairness' require that economic injuries caused by public action [must] be compensated by the government, rather than remain disproportionately concentrated on a few persons. . . ."[87] This determination is "ad hoc and fact intensive" and requires a court to consider the *Penn Central* factors as being particularly significant.[88] A finding of a taking is less likely when interference with property rights "arises from some public program adjusting the benefits and burdens of economic life to promote the common good."[89] However, economic regulation "may nonetheless effect a taking."[90] Therefore, bankruptcy legislation, which transfers value from one party to another can raise the takings issue.[91]

B. *The Bankruptcy Takings Cases*

The Supreme Court has addressed the takings issue in the context of bankruptcy on several occasions, holding each time that the bankruptcy power is limited by the Takings Clause.[92] However, the Supreme Court squarely addressed the bankruptcy takings issue only within the limited framework of an act that retroactively impaired the rights of secured creditors[93] and a railroad reorganization case.[94] In a more recent case, the Court discussed the bankruptcy takings issue but did not reach the issue in its holding.[95]

In *Louisville Joint Stock Land Bank v. Radford*,[96] the Supreme Court addressed the constitutionality of the Frazier-Lemke Act,[97] which gave bankrupt farmers the right, with mortgagee consent, to purchase the

property.").

87. Eastern Enters. v. Apfel, 118 S. Ct. 2131, 2146 (1998) (quoting Kaiser Aetna v. United States, 444 U.S. 164, 175 (1979)) (internal quotation marks omitted in original).

88. *Id.* (citing Kaiser Aetna, 444 U.S. at 175).

89. *Id.* (quoting Penn Central Transp. Co. v. New York City, 438 U.S. 104, 124 (1978)).

90. *Id.* (citing United States v. Security Indus. Bank, 459 U.S. 70, 75 (1982)).

91. *See Security Indus.*, 459 U.S. at 78.

92. *See* United States v. Security Indus. Bank, 459 U.S. 70, 75, 78 (1982); Wright v. Vinton Branch of Mountain Trust Bank, 300 U.S. 440, 456-58 (1937); Louisville Joint Stock Land Bank v. Radford, 295 U.S. 555, 589 (1935); *see also* Continental Ill. Nat'l Bank & Trust Co. v. Chicago, Rock Island, & Pac. Ry., 294 U.S. 648, 669 (1935) (stating that the bankruptcy power is not unlimited); Holt v. Henley 232 U.S. 637, 639 (1914) (holding that an amendment to bankruptcy law must be applied prospectively to avoid affecting existing property rights).

93. *See infra* notes 96-105 and accompanying text.

94. *See infra* notes 119-24 and accompanying text.

95. *See infra* notes 125-32 and accompanying text.

96. 295 U.S. 555 (1935).

97. Pub. L. No. 73-486, 48 Stat. 1289 (1934).

mortgaged property at its appraised value on a payment plan with deferred payments bearing interest at the rate of one percent per annum.[98] If the mortgagee refused to consent to the debtor's purchase of the property, the debtor was given a stay of foreclosure proceedings for five years.[99] During the five year period, the debtor was permitted to retain possession of the property, paying a reasonable annual rent, and was entitled at any time during the five year period to purchase the property for its appraised or reappraised value.[100] The Act applied only to debts existing at the time of its enactment[101] because members of Congress felt that application of the bill to future mortgages would make it impossible for farmers to borrow money.[102]

The Supreme Court unanimously held that the Frazier-Lemke Act violated the Fifth Amendment by taking property rights without just compensation.[103] The Court found that the mortgagee had specific property rights under state law including the mortgagee's right to retain its lien until the debt was paid in full, the right to realize upon its security by judicial foreclosure sale, the right to determine when a foreclosure sale would be held, the right to bid its sale, and the right to control the property during period of default while receiving rents and profits.[104] The Court held that the act violated the Fifth Amendment by taking those rights without just compensation.[105]

After the original Frazier-Lemke Act was declared unconstitutional, Congress amended the Act.[106] The new Frazier-Lemke Act provided for only a three-year stay, rather than the five-year stay provided in the original act, and contained other changes as well.[107] The Supreme Court upheld the constitutionality of the new act in *Wright v. Vinton Branch of Mountain Trust Bank*, finding that the three-year stay was not absolute, but could be terminated by a court.[108] In addition, the Court found that the mortgagee retained the right to a judicial foreclosure sale under certain circumstances.[109] Therefore, the Court concluded that many of the property

98. *See* § 75, 48 Stat. at 1291.
99. *See* § 75(s)(7), 48 Stat. at 1291.
100. *See id.*
101. *See id.*
102. *See* H.R. REP. NO. 2063, at 1 (1934); 78 Cong. Rec. 12,074 (statement of Senator Bankhead); 78 Cong. Rec. 12,075 (1934) (statement of Senator Fess); 78 Cong. Rec. 12,137 (statement of Representative Peyser).
103. *See* Louisville Joint Stock Land Bank v. Radford, 295 U.S. 555, 601-02 (1935).
104. *See id.* at 594-95.
105. *See id.* at 588-90.
106. *See* Act of Aug. 28, 1935, Pub. L. No. 74-384, 49 Stat. 941, 942 (1935).
107. *See id.* § 75(s)(2), 49 Stat. at 944.
108. 300 U.S. 440, 460-61 (1937).
109. *See id.* at 458-59.

rights of the mortgagee were preserved by the new act[110] and that the act modified only the mortgagee's remedial rights.[111] Subsequent cases overruled these interpretations of the new Frazier-Lemke Act. In *John Hancock Mutual Life Insurance Co. v. Bartels*[112] the Supreme Court held that the new act did not provide for dismissal based on lack of a reasonable probability of rehabilitation.[113] In *Wright v. Union Central Life Insurance Co.*,[114] a case involving the same debtor as the *Vinton Branch* case, the Court held that the debtor must be permitted to redeem the property at the appraised or reappraised value before the court could order a judicial foreclosure sale.[115]

While the subsequent cases call into question some details of the holding in *Radford*, they do not call into question the principle that the bankruptcy power is subject to the Fifth Amendment. These subsequent cases simply reassess the relationship between contractual rights and property rights created by a mortgage. Both *John Hancock* and *Union Central* define as the secured creditor's essential property interest the assurance that the value of the mortgaged property will be devoted to the payment of the secured creditor's claim.[116] One possible distinction between the old Frazier-Lemke Act and the new act that could explain these cases is the length of the stay. Under the original act the stay was five years, and under the new act it was only three. Professor Rogers dismisses this distinction as irrational, arguing that *Radford* had been overruled.[117] However, recent cases in the courts of appeals of two circuits have focused on the length of delay imposed on a secured creditor as an important and distinguishing factor.[118]

In 1970, the Supreme Court again discussed the application of the Takings Clause to bankruptcy law in the *New Haven Inclusion Cases*.[119] Secured bondholders of the New York, New Haven & Hartford Railroad argued that a reorganization plan transferring assets of the New Haven Railroad to Penn Central constituted a taking in violation of the Fifth Amendment because the price Penn Central was to pay for the assets was

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110. *See id.* at 458.
111. *See id.* at 470.
112. 308 U.S. 180 (1939).
113. *See id.* at 184.
114. 311 U.S. 273 (1940).
115. *See id.* at 279.
116. *See* 311 U.S. at 278-79; 308 U.S. at 186-87.
117. *See* Rogers, *supra* note 6, at 981-84.
118. *See* Simon v. Cebrick, 53 F.3d 17, 23-24 (3d Cir. 1995); Donna Indep. Sch. Dist. v. Balli, 21 F.3d 100, 101 (5th Cir. 1994); Matagorda County v. Law, 19 F.3d 215, 223 (5th Cir. 1994). *See infra* notes 213-29 and accompanying text.
119. 399 U.S. 392 (1970).

insufficient.[120] The Court held that the bondholders were entitled to the full liquidation value of the assets "by virtue of their mortgage liens"[121] even though the liquidation value exceeded the going concern value of the railroad.[122] However, the bondholders were not entitled to be compensated for their loss due to the delay caused by the reorganization.[123] The Court stressed that the bondholders had "invested their capital in a public utility that does owe an obligation to the public. . . .[They] assumed the risk that in any depression or any reorganization the interests of the public would be considered as well as theirs."[124] Therefore, the Court protected the right of the bondholders to have the value of their collateral applied to the payment of the secured debt, but permitted losses caused by a substantial delay.

The Supreme Court more recently confirmed its continued support for the proposition that bankruptcy law is subject to the Takings Clause in *United States v. Security Industrial Bank*.[125] The *Security Industrial* case involved the interpretation of section 522 (f)(2) of the Bankruptcy Code which permits individuals in bankruptcy to avoid non-possessory, non-purchase money liens on household furnishings, appliances and certain other types of exempt property.[126] The issue in the case was whether this provision was applicable to secured parties who had obtained and perfected their liens on a debtor's household furnishings and appliances before the enactment of the Bankruptcy Code.[127] The majority said that the provision, if applied retroactively, "would result in a complete destruction of the property right of the secured party[.]"[128] The Court distinguished the case from regulatory takings cases "where governmental action affected some but not all of the 'bundle of rights' which comprise the 'property' in question."[129] The fact that the property interest of a secured creditor is smaller than that of a fee simple owner is irrelevant.[130] Although the Court declined to reach the constitutional question of whether the retroactive

120. *See id.* at 400-12.

121. *Id.* at 489-90.

122. *See id.* at 494.

123. *See id.* at 490-91.

124. *Id.* at 491-92 (quoting Reconstruction Finance Corp. v. Denver & R.G.W.R. Co., 328 U.S. 495, 535-536 (1946)). *See generally* J. GREGORY SIDAK & DANIEL F. SPULBER, DEREGULATORY TAKINGS AND THE REGULATORY CONTRACT 11-12 (1997) (arguing that deregulation of a public utility can effect a taking because of investment-backed expectations in the regulatory contract).

125. 459 U.S. 70 (1982).

126. *See* 11 U.S.C. § 522(f)(2) (1988).

127. *See Security Indus.*, 459 U.S. at 71.

128. *Id.* at 75.

129. *Id.*

130. *See id.*

application of the provision would constitute a taking, the Court held that a retroactive application of the provision would raise "substantial enough constitutional doubts. . . ."[131] Therefore, the Court held that the provision must be given prospective effect only.[132]

The Supreme Court has not addressed the bankruptcy takings issue since *Security Industrial. Security Industrial*, while instructive on the bankruptcy takings issue, was actually a case of statutory construction. Therefore, the Court squarely addressed the issue only in the context of the Frazier-Lemke Act, a purely retroactive statute, and a railroad reorganization.[133] Lower courts continue to decide bankruptcy cases involving takings issues, but they differ on how to approach the bankruptcy takings problem.[134] As a result, it is necessary to look to non-bankruptcy takings law to answer most of the questions arising today about takings in bankruptcy.

III. FAULTY ASSUMPTIONS ABOUT THE BANKRUPTCY TAKINGS PROBLEM

Soon after the Supreme Court issued its holding in *Security Industrial*, Professor Rogers considered the case in his article. He concluded that the Takings Clause imposes no limitation on the power of Congress to enact purely prospective legislation impairing security interests, and he criticized the Court's application of the Takings Clause to retroactive legislation.[135] Since its holding in *Security Industrial*, the Supreme Court has decided a number of significant takings cases outside the bankruptcy arena.[136] The Court has made significant changes to takings law during this time period and has adopted an approach to defining the scope of property rights that

131. *Id.* at 74.

132. *See id.* at 82.

133. *See id.* at 70.

134. *Compare* Patriot Portfolio, LLC v. Weinstein (*In re* Weinstein), 164 F.3d 677, 686 (1st Cir. 1999) *and* Bruin Portfolio, LLC v. Leicht (*In re* Leicht), 222 B.R. 670 (B.A.P. 1st Cir. 1998) (following Rogers' approach) *with* United Sav. Ass'n v. Timbers of Inwood Forest Assocs. (*In re* Timbers of Inwood Forest Assocs.), 793 F.2d 1380, 1390, 1390 n.14 (5th Cir. 1986), *aff'd* 484 U.S. 365 (1988) (rejecting Rogers' approach).

135. *See* Rogers, *supra* note 6, at 1031.

136. *See* Eastern Enters. v. Apfel, 118 S. Ct. 2131, 2153 (1998); *see, e.g.*, Phillips v. Washington Legal Found., 118 S. Ct. 1925 (1998); Suitum v. Tahoe Reg'l Planning Agency, 520 U.S. 725 (1997); Babbitt v. Youpee, 519 U.S. 234 (1997); Dolan v. City of Tigard, 512 U.S. 374 (1994); Concrete Pipe & Prods., Inc. v. Construction Laborers Pension Trust, 508 U.S. 602 (1993); Lucas v. South Carolina Coastal Council, 505 U.S. 1003 (1992); Yee v. City of Escondido, 503 U.S. 519 (1992); Nollan v. California Coastal Comm'n, 483 U.S. 825 (1987); Hodel v. Irving, 481 U.S. 704 (1987); Keystone Bituminous Coal Ass'n v. DeBenedictis, 480 U.S. 470 (1987); Connolly v. Pension Benefit Guar. Corp., 475 U.S. 211 (1986); Ruckelshaus v. Monsanto Co., 467 U.S. 986 (1984).

differs from Professor Rogers' approach.[137] Nevertheless, courts have continued to rely on Professor Rogers' reasoning, and scholars proposing changes to the treatment of secured creditors in bankruptcy have assumed the constitutionality of their proposals based on Professor Rogers' conclusions, failing to consider fallacies in his arguments or recent changes in takings jurisprudence.[138]

Some of Professor Rogers' conclusions were incorrect. Others were normative and should, therefore, not be the basis for assumptions about the constitutionality of proposals. Finally, some of his reasoning has been rejected by the Supreme Court in cases that it decided since he published his article. In this section, I will address the validity of Professor Rogers' conclusions as well as other underlying assumptions that courts or scholars have relied upon in assessing the constitutionality of current law and of proposals for changing the treatment of secured creditors in bankruptcy.

A. *Faulty Assumption #1: The Takings Clause Imposes No Significant Limitation on the Bankruptcy Power*

In his article, Professor Rogers concluded:

> Justice Brandeis' famous statement in the Radford case that "[t]he bankruptcy power . . . is subject to the Fifth Amendment," . . . is in fact false. The only significant constitutional restraint on the substance of purely prospective bankruptcy legislation is the bankruptcy clause itself. Even in the context of retroactive application of bankruptcy legislation, the effort to deduce controlling principles from general principles about property rights . . . proves far less successful than an approach that draws more heavily on bankruptcy principles . . . .[139]

Therefore, Professor Rogers would look only to the Bankruptcy Clause in determining the constitutionality of bankruptcy legislation. Some courts have adopted his reasoning.[140]

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137. *See infra* Part III.C. Even before his article, the Court had rejected his assertion that the rights of secured creditors are no different from the rights of unsecured creditors. *See infra* notes 172-74 and accompanying text.

138. *See* Bebchuk & Fried, *The Uneasy Case*, *supra* note 2, at 932; LoPucki, *supra* note 1, at 1952-54; *see also* Knippenberg, *supra* note 16 at 1974 (citing Professor Rogers in support of Professor LoPucki's proposal).

139. Rogers, *supra* note 6, at 1031 (footnotes omitted).

140. Courts have quoted Professor Rogers as follows:

> [T]he famous statement that the bankruptcy power is subject to the fifth amendment must be taken to mean nothing more than that the fifth amendment,

Professor Rogers' conclusion is inconsistent with the Supreme Court's interpretation of the relationship between the two clauses as well as with established understandings of Constitutional interpretation. The Supreme Court has addressed the limitations imposed by the Takings Clause upon retroactive bankruptcy legislation.[141] Although the Court has not addressed the takings issue with respect to prospective bankruptcy legislation, the Court has never indicated that the Takings Clause becomes irrelevant in such a case. Courts and scholars interpreting potentially conflicting constitutional provisions should read them in a way to give effect to both.[142] The Bankruptcy Clause and the Takings Clause can be read together in a logical way that does give effect to both.

In order to comply with the Fifth Amendment, regulations must advance legitimate governmental interests.[143] Whether this requirement comes from the Due Process Clause or the Takings Clause and whether the level of scrutiny is heightened or not in a case not involving exactions is not important in this analysis.[144] This prong of the takings formula is the one that considers whether Congress is acting within the scope of the bankruptcy power, but the remainder of the takings formula cannot be ignored. This is the flaw in Professor Rogers' reasoning that the bankruptcy power is not limited by the Fifth Amendment. While the power of Congress to enact bankruptcy legislation is relevant in the takings analysis,[145] it does not end the inquiry. Other factors must be considered in determining if bankruptcy legislation is a taking of property without just

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> through either the due process clause or the takings clause, is the constitutional foundation for the proposition that statutes that retroactively disrupt settled expectations may be subject to particularly attentive judicial scrutiny.

Travelers Ins. Co. v. Burlington, 878 F.2d 354, 359 n.6 (1989) (quoting Rogers, *supra* note 6, at 985); *see* Yi v. Citibank, 219 B.R. 394, 402 (E.D. Va. 1998).

141. *See supra* notes 96-105 and accompanying text.

142. *See* LAURENCE H. TRIBE & MICHAEL C. DORF, ON READING THE CONSTITUTION 20-23 (1991). Professors Tribe and Dorf say that the Constitution should not be read by "dis-integration," which they define as "approaching the Constitution in ways that ignore the salient fact that its parts are linked into a whole–that it is *a Constitution*, and not merely an unconnected bunch of separate clauses and provisions with separate histories, that must be interpreted." *Id.* at 20. They continue: "It is a dis-integrated 'reading' of the Constitution to lift one provision out, hold it up to the light, and give it its broadest possible interpretation, while ignoring the fact that it is immersed in a larger whole." *Id.* at 22.

143. *See supra* notes 80-82 and accompanying text.

144. *See supra* notes 83-85 and accompanying text.

145. For purposes of this Article, I will assume a substantial relationship exists and will continue with the remainder of the analysis required by recent Supreme Court cases. Any legislation that is within the scope of the Bankruptcy Clause would be rationally related to the bankruptcy power. Whether the legislation was substantially related would depend upon the particular legislation.

compensation.

B. *Faulty Assumption #2: A Security Interest Is Not an Interest in Property*

Bankruptcy limitations on secured creditors raise the takings issue only if secured creditors have property rights.[146] If security interests are only contract rights, then they can be impaired in the same manner as unsecured debts in bankruptcy. Although contract rights have been treated as property for some purposes,[147] governmental interference with contract rights has not been treated as a taking.[148] Contract rights can be impaired in bankruptcy because the Contracts Clause of the Constitution applies only to the states, not to the federal government.[149] If security interests are property rights, then the Takings Clause, rather than the Contracts Clause, is at issue.

Several scholars involved in the secured credit debate have discussed the issue of whether a security interest constitutes a property interest. A number of scholars take the view that a security interest is a property interest.[150] Some, while acknowledging that a security interest is currently treated as a property interest, take the normative view that it should not be so treated.[151] Others scholars refuse to acknowledge that a security interest

146. The threshold question in determining if there has been a taking is whether the affected interest is recognized as property. *See supra* note 22 and accompanying text.

147. Contract rights are property rights for purposes of the Due Process Clause. *See* Lynch v. United States, 292 U.S. 571, 579 (1934); Sinking Fund Cases, 99 U.S. 700, 718-19 (1878). An unsecured claim also is property for purposes of the Due Process Clause. *See* Tulsa Professional Collection Services v. Pope, 485 U.S. 478, 485 (1988).

148. *See* United States v. Security Indus. Bank, 459 U.S. 70, 75 (1982). *But see* RICHARD A. EPSTEIN, TAKINGS: PRIVATE PROPERTY AND THE POWER OF EMINENT DOMAIN 88 (1985) ("[C]ontract rights created by a voluntary exchange are protected by the eminent domain clause."). Professor Laitos theorizes that "a contract would not be property under the Takings Clause when nullified by Congress acting within its powers, and when that congressional action had taken nothing for its own use." LAITOS, *supra* note 22, § 5.02[A].

149. *See* U.S. CONST. art. I, § 10, cl. 1; Continental Ill. Nat'l Bank & Trust Co. v. Chicago, Rock Island & Pac. Ry., 294 U.S. 648, 680 (1935).

150. *See, e.g.*, Baird, *Security Interests Reconsidered*, *supra* note 2, at 2257; Bowers, *supra* note 2, at 59 n.85 ("The Bankruptcy Code does not accord a priority to secured lenders. It simply refuses to distribute other people's property to the creditors of the debtor but instead distributes property to those who own it."); Harris & Mooney, *A Property-Based Theory*, *supra* note 2, at 2051. Professors Harris and Mooney base their argument in support of secured credit on the assumption that a security interest is an interest in property. *Id.* at 2051-53.

151. This is the approach of Professors Ponoroff and Knippenberg, who believe that a security interest should be reconceptualized in bankruptcy, not as a right in property, but as a claim to property up to the value of the collateral at the time of filing. *See* Lawrence Ponoroff & F. Stephen Knippenberg, *The Immovable Object Versus the Irresistible Force: Rethinking the Relationship Between Secured Credit and Bankruptcy Policy*, 95 MICH. L. REV. 2234, 2290-94 (1997). Their

is an interest in property or avoid the issue altogether.[152] Professor Rogers argues that a secured creditor does not acquire property rights which should be accorded greater protection than the contract rights of an unsecured creditor.[153] Thus, although many scholars may take the normative view that a security interest should not be treated as a property interest, few scholars are willing to say that a security interest is not an interest in property.[154] With the law as it stands, those scholars who refuse to admit that a security interest is property are letting their normative view influence their conclusions.

Property rights are not defined by the Constitution, but rather "by reference to 'existing rules or understandings that stem from an independent source such as state law.'"[155] Bankruptcy law also does not generally define property rights but rather defers to state law.[156] Clearly

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article focuses on the nature of a security interest as property in the context of *Dewsnup v. Timm*, 502 U.S. 410 (1992). Ponoroff and Knippenberg consider experiential realism, which focuses on the role of metaphor in human conceptual systems. The experientialist would view legal concepts as "metaphoric constructs that enable meaning in accordance with . . . goals and purposes, rather than abstractions of things the way they really are." *Id.* at 2283. Under this theory, property, in reality a physical thing, is just a metaphor with respect to a security interest. The property metaphor is useful in defining security, and in dealing with state law issues relating thereto, but is not so useful in the context of bankruptcy. *See id.* at 2285, 2291. They argue that the treatment of a security interest as a property right in bankruptcy can be abandoned because it is only a metaphor, not reality. *See id.* at 2269-70; *see also* Knippenberg, *supra* note 16, at 1975 (describing the conveyance model of a security interest as a metaphor). However, the treatment of any intangible property right as "property" is in a sense a metaphor. *See Plank, supra* note 22, at 1200-07 (discussing the difference between the use of the term property in its colloquial sense to mean "the thing" and the use of the term in its more technical sense to mean an interest in property).

152. Professor LoPucki eschews the property based theory, although he does not come right out and say that a security interest is not an interest in property. LoPucki, *supra* note 1, at 1952-53. Professors Warren and LoPucki carefully avoid calling a security interest an interest in property in their textbook on secured credit, defining a lien as "the relationship between particular property (the *collateral*) and a particular debt or obligation." LYNN L. LOPUCKI & ELIZABETH WARREN, SECURED CREDIT: A SYSTEMS APPROACH 24 (2d ed. 1998) (emphasis in original). Professors Bebchuk and Fried refuse to address the issue, saying that a security interest gives a secured creditor a "repossessory right" and a "priority right" in order to stay clear of the property issue. *See* Bebchuk & Fried, *The Uneasy Case*, *supra* note 2, at 860, n.8.

153. *See* Rogers, *supra* note 6, at 988-94; *see also* Klee, *supra* note 2, at 1476-77 (stating that a "lien might be regarded as a contract right or interest in property, rather than property itself.").

154. *But see* Steve H. Nickles, *Commercial Law Consequences of the Bankruptcy System: Urging the Merger of the Article 9 Drafting Committee and the Bankruptcy Commission*, 69 AM. BANKR. L.J. 589, 593 (1995) (stating that "[T]here are rumors of some developing academic support for the notion that liens are not property.").

155. Phillips v. Washington Legal Found., 118 S. Ct. 1925, 1930 (1998) (quoting Board of Regents of State Colleges v. Roth, 408 U.S. 564, 577 (1972)); *see* Ruckelshaus v. Monsanto Co., 467 U.S. 986, 1001 (1984); Hughes v. Washington, 389 U.S. 290, 295 (1967).

156. *See* Nobelman v. American Sav. Bank, 508 U.S. 324, 329 (1993); Barnhill v. Johnson, 503 U.S. 393, 398 (1992); Butner v. United States, 440 U.S. 48, 54-55 (1979). In *Butner*, the

under existing state law, both Article 9 security interests and consensual liens in real property are interests in property.[157] Mortgages and deeds of trust convey an interest in real property.[158] Some states treat the mortgagee's interest as title, while others treat the interest as a lien, depending upon whether the mortgagee has a technical right to take possession of the property.[159] Even lien theory states, however, recognize that the mortgagee's interest is an interest in real property.[160] Security interests in personal property are similarly treated as property interests under state law.[161] The Bankruptcy Code definition of a lien includes an interest in property.[162] Furthermore, the Supreme Court has recognized that a security interest is an interest in property.[163] The law does treat and historically has treated the interest of a secured creditor in either real or personal property as an interest in the property. While this treatment may simply be an accident of history,[164] history did treat the security interest as an interest in property.[165]

Supreme Court said, "Congress has generally left the determination of property rights in the assets of a bankrupt's estate to state law." 440 U.S. at 54.

157. *See* RESTATEMENT (THIRD) OF PROPERTY: MORTGAGES § 1.1 (1997) ("A mortgage is a conveyance or retention of an interest in real property as security for performance of an obligation."); U.C.C. § 1-201(37) ("'Security interest' means an interest in personal property . . . .").

158. *See* RESTATEMENT (THIRD) OF PROPERTY: MORTGAGES § 1.1 (1997).

159. Under modern American law, only a few states retain the "title" model of the mortgage, under which the mortgagee is theoretically entitled to possession of the property upon execution of the mortgage. *See* 1 GRANT S. NELSON & GALE A. WHITMAN, REAL ESTATE FINANCE LAW § 4.1 (3d ed. 1994). In fact, modern mortgagees rarely take possession of mortgaged property even in those states in which they are entitled to do so. *See id.* Other jurisdictions, called "intermediate" or "lien theory" states permit a mortgagee to take possession of mortgaged property only upon default or only upon foreclosure. *See id.* §§ 4.2-.3. In fact, all of this makes little difference except on the issue of pre-foreclosure remedies. *See id.* §§ 4.1-.3. Regardless of whether a jurisdiction is classified as lien theory, title theory or intermediate, the mortgagee has what is commonly referred to as a lien, which is a property interest, although in almost all instances, a non-possessory interest. *See* RESTATEMENT (THIRD) OF PROPERTY: MORTGAGES § 1.1 cmt. (1997).

160. *See* RESTATEMENT (THIRD) OF PROPERTY: MORTGAGES § 1.1 cmt.(1997).

161. *See* U.C.C. § 1-201(37).

162. *See* 11 U.S.C. § 101(37) (1994) (stating "'lien' means charge against or interest in property to secure payment of a debt or performance of an obligation").

163. *See* United States v. Security Indus. Bank, 459 U.S. 70, 76 (1982); Armstrong v. United States, 364 U.S. 40, 46 (1962); *see also* Louisville Joint Stock Land Bank v. Radford, 295 U.S. 555, 588 (1935) (explaining that secured creditors have rights in specific property).

164. *See* Rogers, *supra* note 6, at 994.

165. The mortgage of 14th century England, a forebearer of the American mortgage, was a conveyance of a fee simple from the borrower to the lender, subject to a condition subsequent. *See* NELSON & WHITMAN, *supra* note 159, § 1.2; Robert Kratovil, *Mortgages–Problems in Possession, Rents, and Mortgagee Liability*, 11 DEPAUL L. REV. 1, 1 (1961). The conveyance gave the lender all incidents of legal title, including the right to take possession of the property. *See* NELSON & WHITMAN, *supra*, § 1.2. Early mortgage lenders actually took possession of property and collected

Just what is the nature of a security interest in the bundle of property rights? A security interest in real property is created by grant to the mortgagee or to a trustee. The interest granted is generally non-possessory, but with the right of the lender in many states to take possession upon default.[166] The interest terminates upon payment in full of the debt, although the lender (or trustee) is typically required to execute a release of the mortgage. During the term of the mortgage, the lender is protected by common law concepts of waste. The interest includes a right to a foreclosure that cuts off any rights of the borrower, either judicially or non-judicially, resulting in nothing more than payment of net sale proceeds up to the amount of the debt to the lender. As a matter of fact, the lender is almost always the successful bidder at a foreclosure sale; however, except in a few states, where strict foreclosure is allowed under certain circumstances,[167] there is no right in the lender to ultimately own the property except by being the successful bidder at a foreclosure sale.

An Article 9 security interest is created by a security agreement.[168] The secured party is not required to, but may, take possession of the collateral. The secured party is entitled to take possession upon default in the absence of an agreement to the contrary.[169] Strict foreclosure is permitted only if the debtor does not object.[170] Otherwise, the secured party usually forecloses by conducting a commercially reasonable sale of the collateral.[171]

What then is the property right of a secured creditor? The Supreme Court has held that it is the right to have the value of the collateral applied

rents and profits from the property as a form of interest at a time when interest was forbade by law. *See id.* If the borrower repaid the debt on the required day, the borrower could reenter the property and terminate the lender's interest, but if the borrower failed to perform as required, the lender's estate would become absolute. *See id.* Later, equity courts intervened to create a process of strict foreclosure, which was required in order to cut off the borrower's equity of redemption, or right to repay the debt and get the property back. *See id.* § 1.3. The personal property security interest, although having a different historical background, was similarly treated as creating a property interest in the secured creditor. *See* Harris & Mooney, *A Property-Based Theory*, *supra* note 2, at 2051.

166. The lender has the right to take possession upon default in title theory states, in intermediate states, and by agreement in many lien theory states. *See* NELSON & WHITMAN, *supra* note 159, §§ 4.1-.3.

167. *See id.* § 7.10.

168. *See* U.C.C. § 9-203. The agreement must be in writing unless the secured party has taken possession of the collateral. *See id.* § 9-203(1)(a). In addition, value must be given, and the debtor must have rights in the collateral. *See id.* § 9-203(1)(b)-(c).

169. *See* U.C.C. § 9-503.

170. *See* U.C.C. § 9-505(b).

171. *See* U.C.C. § 9-504. Other remedies include foreclosure with real property, § 9-501(4), judicial sale, § 9-501(5), or collection of funds from an account debtor, § 9-502. *See id.* §§ 9-501(4), 9-501(5), 9-502.

to payment of the secured creditor's claim.[172] The remainder of a secured creditor's rights are contract rights.[173] The Supreme Court has stated that "our cases recognize, as did the common law, that the contractual right of a secured creditor to obtain repayment of his debt may be quite different in legal contemplation from the property right of the same creditor in the collateral."[174] Professor Rogers may take the normative view that the rights of a secured creditor should be treated no differently from those of an unsecured creditor, but the Supreme Court has taken a different view.[175] The fact that specific property is identified for payment of a secured claim does make a security interest different from the rights of an unsecured creditor. Because Professor Rogers' view is normative, it should not be the basis for assumptions about the constitutionality of proposals for change in bankruptcy law.

Scholars may argue that property rights should not be given the deference that they are accorded in bankruptcy or that property rights of secured creditors should not be treated differently from contractual rights of unsecured creditors as a matter of distributive justice.[176] Ultimately, while arguments about whether a security interest should be an interest in property are interesting and valuable, they do not reflect the current state of the law. These normative views should not be used as the basis for assumptions about the constitutionality of proposed changes to bankruptcy law.

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172. *See* Wright v. Union Cent. Life Ins. Co., 311 U.S. 273, 278-79 (1940); John Hancock Mut. Life Ins. Co. v. Bartels, 308 U.S. 180, 186-87 (1939).

173. With respect to real property, a mortgage or deed of trust is frequently a very extensive contractual agreement between borrower and lender, imposing numerous obligations upon the borrower that are more or less related to the land. In fact, the modern mortgage or deed of trust may best be described as having the dual nature of conveyance and contract, similar to a lease. A security agreement also has numerous contractual provisions in addition to the grant of the security interest.

174. United States v. Security Indus. Bank, 459 U.S. 70, 75 (1982).

175. *See id.*

176. It is one matter to propose changes to bankruptcy law on the basis of what the law should be. It is quite another to assert that a security interest should not be treated as an interest in property. I do not mean to imply that legal scholarship should not venture into this realm. It certainly should. However, a change to a federal bankruptcy statute is a realistic possibility that could occur in an upcoming session of Congress. Changes in the common law understanding of a security interest as property are not so easy. The treatment of a real property security interest as a property interest is based on common law, which varies greatly from state to state. It is unlikely to change anytime soon. In addition, state legislatures have been unwilling to pass uniform legislation in the area of real property security. Even in the area of personal property, a recent revision of Article 9 did not incorporate such a change. Although property rights can be created by federal law, the federal government cannot define away property rights created under state law. *See infra* subpart C.

C. *Faulty Assumption #3: New Bankruptcy Legislation Redefines the Property Interest of a Secured Creditor*

Professor Rogers assumed that the property rights of secured creditors are redefined by changes in bankruptcy law. Therefore, because security interests are defined to include any new limitations imposed on them, no taking can occur because of newly imposed limitations so long as they are prospective.[177] Some courts and scholars have adopted his reasoning in discussing the constitutionality of current and proposed bankruptcy law.[178]

The Supreme Court has implicitly rejected Professor Rogers' approach to defining the property rights of secured creditors. In determining the extent of the property interest at issue, the Court looks to "background principles" of property law, a phrase that originated in *Lucas v. South Carolina Coastal Council.*[179] In *Lucas*, the Court found an exception to its categorical taking rule requiring compensation if the state denies all economically beneficial use of land where "the proscribed use interests were not part of [the owner's] title to begin with."[180] In defining the preexisting limitations upon the owner's title, the Court looked to "background principles of the State's law of property and nuisance."[181] In discussing background principles, the Court excluded "newly legislated or decreed" limitations on title.[182]

The Court's exception for preexisting limitations on title has generated a substantial amount of commentary. Scholars have struggled to determine what law can be considered background principles.[183] Scholars have questioned whether background principles must come from state common law or whether state or federal legislation could also be included in background principles.[184] Some scholars have argued that there is no logical reason to exclude federal or state legislation.[185] Even assuming, however, that federal legislation such as the Bankruptcy Code could

177. *See* Rogers, *supra* note 6, at 987 n.59.

178. *See* Patriot Portfolio, LLC v. Weinstein (*In re* Weinstein), 164 F.3d 677, 686 (1st Cir. 1999) ("Because Patriot's property rights in the lien are circumscribed by the debtor's ability under the Code to avoid the lien, prospective application of § 522(f) does not constitute a 'taking' of Patriot's property interest . . . ."); Carlson, *supra* note 15, at 585.

179. 505 U.S. 1003, 1029 (1992).

180. *Id.* at 1027.

181. *Id.* at 1029. Although the exception has been called a "nuisance exception," the Court did not limit it to nuisance law but included background principles of property law. *Id.*

182. *Id.*

183. *See* Lynn E. Blais, *Takings, Statutes, and the Common Law: Considering Inherent Limitations on Title*, 70 S. CAL. L. REV. 1, 5 (1996); Fred P. Bosselman, *Limitations Inherent in the Title to Wetlands at Common Law*, 15 STAN. ENVTL. L.J. 247, 328-29 (1996).

184. *See* Blais, *supra* note 183, at 1; Bosselman, *supra* note 183, at 328-29.

185. *See* Blais, *supra* note 183 at 49-51.

constitute background principles, it seems that recent enactments cannot.

The Supreme Court recently elaborated on its understanding of background principles in *Phillips v. Washington Legal Foundation.*[186] The *Phillips* case involved a challenge to the Texas Interest on Lawyer's Trust Account (IOLTA) program, which requires that interest from most client trust funds be paid to a foundation to be used to provide legal services for low income persons.[187] The only issue addressed in the case was whether the interest income generated by IOLTA accounts was private property under the Takings Clause.[188] The Court looked to "background principles of property law" in determining that the right to interest was a property right, but did not consider the IOLTA statute itself as one of the background principles defining the property interest.[189] The petitioners had argued that a client could have no expectation of interest on trust fund accounts and, therefore, no property interest.[190] The Supreme Court disagreed, stating "'a State by *ipse dixit,* may not transform private property into public property without compensation' simply by legislatively abrogating the traditional rule . . . ."[191] Presumably Congress also may not redefine traditional property interests in order to avoid a takings problem. Therefore, new bankruptcy legislation would not redefine the property rights of secured creditors.

D. *Faulty Assumption #4: Secured Creditors Are the Only Parties Affected by Changes to the Treatment of Security Interests in Bankruptcy*

Professor Rogers failed to consider the impact of prospective changes in the treatment of secured creditors in bankruptcy on property owners' ability to create security interests. In discussing his view of prospective legislation, he stated:

> As soon as the government announced that a certain use of land would henceforth be prohibited or that certain land might be taken without compensation at some time in the future, the value of the affected land would be diminished, to the detriment of its current owner. There can be no new land; there can, however, be new security arrangements.[192]

186. 118 S. Ct. 1925 (1998).
187. *See id.* at 1927-28.
188. *See id.* at 1926.
189. *See id.* at 1930-32.
190. *See id.* at 1931.
191. *Id.*(quoting Webb's Fabulous Pharm. v. Beckwith, 449 U.S. 155, 164 (1980)).
192. Rogers, *supra* note 6, at 987 n.59.

He failed to recognize that property owners would be affected by the inability to convey security interests that could survive bankruptcy. The Supreme Court has recognized that a taking of certain strands in a property owners bundle of rights can be a taking without just compensation under the Fifth Amendment.[193] For example, the right to exclude others from property and the right to transfer property by descent or devise are such essential rights in the bundle.[194] Therefore, the rights of property owners as well as secured parties must be considered in addressing the constitutionality of proposed changes to the treatment of security interests in bankruptcy.[195]

E. *Faulty Assumption #5: If Current Limitations on the Rights of Secured Creditors Are Constitutional, Additional Limitations Must Be Also*

Finally, some scholars have assumed that because current law imposes limitations on the rights of secured creditors and permits the avoidance of liens in certain circumstances, additional limitations would not create a takings problem.[196] However, this assumption is not correct. In determining whether a taking has occurred, courts must apply an ad hoc test which is fact intensive.[197] Concluding that one type of limitation on the property rights of secured parties in bankruptcy creates no takings problem does not require the conclusion that other limitations are also acceptable.

IV. APPLICATION OF TAKINGS JURISPRUDENCE TO EXISTING AND PROPOSED BANKRUPTCY LAW

Despite the fallacy of Professor Rogers' conclusions, either initially or as a result of changes in takings jurisprudence, courts and scholars have continued to rely upon them. Therefore, the application of takings doctrine to bankruptcy law must be reconsidered. In this section of the Article, I will conduct an analysis of current and proposed bankruptcy law using takings doctrine as it has developed over the past fifteen years. I will first consider current bankruptcy law, with a particular emphasis on the problem of delay and on lien avoidance provisions. Next, I will explore the

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193. *See infra* Part IV.B.1.

194. *See* Hodel v. Irving, 481 U.S. 704, 715-16 (1987); Kaiser Aetna v. United States, 444 U.S. 164, 176 (1979). These cases are discussed in Part IV.B.1.

195. At least some scholars involved in the secured credit debate have considered the rights of property owners in their discussions of takings issues. *See* Bebchuk & Fried, *Further Thoughts*, *supra* note 2, at 1290; Klee, *supra* note 2, at 1476.

196. *See* Bebchuk & Fried, *Further Thoughts*, *supra* note 2, at 1291 ("[T]his would imply that fraudulent conveyance law, preference law, and the rule of mandatory pro rata sharing all violate the borrower's property rights."). Professor Rogers did not make this argument.

197. *See supra* notes 87-88 and accompanying text.

assumption of Professor Rogers and other scholars that security interests could be completely invalidated in bankruptcy without running afoul of the Takings Clause. Finally, I will consider a partial priority rule such as the one proposed by Professors Bebchuk and Fried.

A. *Current Bankruptcy Law*

1. The Problem of Delay

Current bankruptcy law gives great deference to the interests of secured creditors.[198] Unless their liens are avoided, secured creditors are ultimately entitled to the full amount of their secured claims. The only impairment of secured claims under current law is caused by the delay between the filing of bankruptcy, which stays state law collection actions, and the secured creditor's actual receipt of payment pursuant to a liquidation or a plan of reorganization. In the case of a Chapter 7 liquidation, the delay tends to be insignificant. In the case of a reorganization, the delay can be significant. The Bankruptcy Code provides for a period of 180 days during which the debtor has the exclusive right to file a plan of reorganization.[199] The period of exclusivity is frequently extended so that the plan is not actually confirmed for many months or even years in some cases.[200] During the period prior to confirmation of a plan, an oversecured creditor is entitled to accruing interest as a part of the secured claim.[201] Undersecured creditors, however, are not entitled to interest on their claims to compensate for delay in bankruptcy.[202] Even undersecured creditors may be entitled to receive rents from income-producing real property to the extent that rents exceed expenses of the property.

Amendments to the Bankruptcy Code made in 1994 helped the position of certain real property secured creditors. First, special provisions were added for single asset real estate cases. Although single asset real estate cases were defined narrowly to include only cases involving no more than \$4 million of secured debt,[203] delays in these cases were limited by requiring the debtor to either file a plan of reorganization or commence

198. *See supra* notes 51-53 and accompanying text.

199. *See* 11 U.S.C § 362(d)(1).

200. *See* Lynn M. LoPucki & William C. Whitford, *Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 141 U. PA. L. REV. 669, 693 (1993). Professors LoPucki and Whitford did an empirical study of bankruptcies of the 43 largest publicly held companies filing and completing bankruptcy during the period of their study. *See id.* at 675. They found that the bankruptcy judge had extended the exclusivity period for the duration of the case in 34 of those 43 bankruptcy cases. *See id.* at 693.

201. *See id.* § 506(b).

202. *See* United Sav. Ass'n v. Timbers of Inwood Forest Assocs., 484 U.S. 365, 382 (1988).

203. *See* 11 U.S.C. § 101(51B).

interest payments within ninety days.[204] Second, changes were made to the Bankruptcy Code to clarify the right of mortgage lenders with a duly recorded assignment of rents to receive net rents from the property during the pendency of the bankruptcy proceeding.[205] Despite these changes, it is still possible under the Bankruptcy Code for certain undersecured creditors to experience significant delays during which there is no compensation for their lost opportunity cost. The question then is whether this delay can create a takings claim.

Although bankruptcy law has historically given great deference to security interests, there is historical support for the concept of a stay. Although early bankruptcy statutes did not provide for an automatic stay, the debtor could request a stay from the court.[206] Since 1978, the stay has been automatic.[207] This history suggests that there is nothing inherently unconstitutional about the concept of the automatic stay. In *United Savings Association v. Timbers of Inwood Forest Associates*, the Supreme Court held that undersecured creditors are not entitled to interest on their claims.[208] Although the Supreme Court did not address the takings issue, it affirmed the decision of the Fifth Circuit in which the takings issue was addressed.[209]

The automatic stay, with its resulting delay to secured creditors, constitutes regulation of the secured creditor's property interest. Therefore, in determining whether there has been a taking, the question is whether the regulation goes too far. Under the analysis of *Lucas*, there is no physical invasion or denial of all economically beneficial use of the property interest. Therefore, the ad hoc approach of *Penn Central* must be applied.

The Supreme Court has made clear that the damages remedy is available for a temporary regulatory taking.[210] In *First English*, the Court addressed the issue of whether the Takings Clause required compensation

204. *See id.* § 362(d)(3).

205. *See id.* § 522(b). For a discussion of the problem that this section was designed to resolve, see generally Craig H. Averch, *Revisitation of the Fifth Circuit Opinions of Village Properties and Casbeer: Is Post-Petition "Perfection" of an Assignment of Rents Necessary to Characterize Rental Income as Cash Collateral?*, 93 COM. L.J. 516 (1988); Julia Patterson Forrester, *A Uniform and More Rational Approach to Rents as Security for the Mortgage Loan*, 46 RUTGERS L. REV. 349, 386-96 (1993); *see, e.g.*, James McCafferty, *The Assignment of Rents in the Crucible of Bankruptcy*, 94 COM. L.J. 433 (1989); Patrick A. Randolph, Jr., *Recognizing Lenders' Rents Interests in Bankruptcy*, 27 REAL PROP., PROB. & TR. J. 281 (1992); Glenn R. Schmitt, *The Continuing Confusion Over Real Property Rents as Cash Collateral in Bankruptcy: The Need for a Consistent Interpretation*, 5 DEPAUL BUS. L.J. 1 (Fall/Winter 1992-93).

206. *See infra* notes 233-36 and accompanying text.

207. *See* 11 U.S.C. § 362(a).

208. 484 U.S. 365, 382 (1988).

209. 793 F.2d 1380, 1390 n.14 (5th Cir. 1986).

210. *See* First English Evangelical Lutheran Church v. County of Los Angeles, 482 U.S. 304, 318 (1987).

for regulatory takings that were temporary because they were ultimately invalidated.[211] The Court found that "'temporary' takings . . . are not different in kind from permanent takings, for which the Constitution clearly requires compensation."[212] Therefore, delay in a secured creditor's ability to exercise remedies could conceivably create a takings claim.

Relevant to this inquiry of whether delay in bankruptcy could present a takings claim are several United States Court of Appeals cases addressing the takings issue when a lienholder was prevented from foreclosing because of the existence of an inferior FDIC lien on property.[213] Each of these cases involved a provision of the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA) that provides that property of the FDIC may not be foreclosed without the FDIC's consent.[214] This provision has been interpreted to require the FDIC's consent in order for a prior lienholder to foreclose and wipe out a lien held by the FDIC.[215]

In *Matagorda County v. Law*, local taxing authorities sued to foreclose tax liens that were prior to a lien owned by the FDIC.[216] The taxing authorities were prohibited from foreclosing for twenty-seven months, and claimed a taking of their property rights based on the delay.[217] The court applied the ad hoc test to ultimately determine that there was no taking.[218] With respect to the economic impact of the FIRREA provision, the court found that "mere delay—at least the period of delay experienced to this point—does not infringe on Appellants' total 'bundle' of rights to the point of creating a compensable taking."[219] With respect to investment-backed expectations, the court noted that banking has long been a highly regulated industry; however, prior to FIRREA, the taxing authorities would have been able to enforce their tax liens.[220] With respect to the character of the governmental action, the court found no physical invasion or permanent appropriation; however, the court noted that "[u]nmitigated delay, coupled with diminishment of distinct investment-backed expectations, *may, at some point*, infringe on the entire 'bundle' of rights . . . to the point that a

211. *See id.*
212. *Id.*
213. *See* Simon v. Cebrick, 53 F.3d 17, 18-19 (3d Cir. 1995); Donna Indep. Sch. Dist. v. Balli, 21 F.3d 100, 100 (5th Cir. 1994); Matagorda County v. Law, 19 F.3d 215, 218-23 (5th Cir. 1994).
214. 12 U.S.C. 1825(b)(2); *see Simon*, 53 F.3d at 19-20; *Balli*, 21 F.3d at 101; *Law*, 19 F.3d at 218.
215. *See Simon*, 53 F.3d at 22; *Law*, 19 F.3d at 222-23; FDIC v. Lowrey, 12 F.3d 995, 996 (10th Cir. 1993).
216. 19 F.3d at 217.
217. *See id.* at 223, 225 n.11.
218. *See id.* at 223-25.
219. *Id.* at 224.
220. *See id.*

compensable taking occurs."[221] Although the court found no taking in a delay of two years and three months, the court stated that this much delay approached the maximum amount of delay that would be permitted without finding a taking.[222]

In *Donna Independent School District v. Balli*, decided only a month after *Matagorda County*, the Fifth Circuit Court of Appeals again found no taking in a case where taxing authorities were delayed in their ability to foreclose because of an inferior FDIC lien.[223] In this case, the delay was significantly longer; however, the value of the property was sufficient to pay both the entire amount of the tax liens and the entire amount of the FDIC lien.[224] Therefore, the taxing authorities could have sold the property subject to the FDIC lien.[225] Under these circumstances, the Fifth Circuit was unwilling to find a taking.[226]

In *Simon v. Cebrick*, the Third Circuit Court of Appeals found there was no taking where a taxing authority's delay in foreclosing was one year and seven months.[227] The FDIC argued that the delay could not constitute a taking since the taxing authority was accruing interest and the value of the property was far in excess of the tax lien amount.[228] Although finding no taking, the court stated that "at some point a delay in the ability to exercise property rights may constitute a compensable taking."[229]

These cases suggest that at some point the operation of the automatic stay in bankruptcy could constitute a taking. The argument would have to be made with respect to an undersecured claim not entitled to the accrual of interest and under circumstances in which the secured creditor was not able to collect rent in order to receive compensation for lost opportunity cost. Conceivably, if the delay caused by the automatic stay continued long enough, there could be a taking. In Chapter 11 cases, debtors in some bankruptcy cases are able to obtain multiple extensions of the exclusivity period, so cases of extreme delay do exist.[230] The *New Haven Inclusion Cases*, discussed above, can be distinguished because the Supreme Court

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221. *Id.* at 225.
222. *See id.* at 225 n.11.
223. 21 F.3d at 100.
224. *See id.*
225. *See id.*
226. *See id.*
227. 53 F.3d at 24.
228. *See id.*
229. *Id.*
230. *See, e.g., In re* Ames Dep't Stores, No. M-47 (PKL), 1991 W.L. 259036, at *1 (S.D.N.Y. Nov. 25, 1991) (discussing Bankruptcy Court's grant of nine extensions of the exclusivity period, with the total exclusivity period running from the April 25, 1990, filing date to the January 10, 1992, final extension date); *see also* LoPucki & Whitford, *supra* note 200, at 693 (discussing the prevalence of long extensions of the exclusivity period in the reorganizations they studied).

relied on the special nature of investment in a public utility such as a railroad in holding that the bondholders in that case were not entitled to compensation for an extraordinary delay.[231]

If a delay in foreclosure caused by FIRREA can be a taking, is the same true of a delay caused by the automatic stay? The economic impact of the regulation and the character of the governmental action are the same. The lender's investment-backed expectations might be slightly different. The Fifth Circuit in *Matagorda County* said that banking is a regulated industry and that parties who deal with regulated industries are on notice that Congress may act with respect to them.[232] However, it was only after the enactment of FIRREA in 1989 that prior lienholders were delayed in the enforcement of their liens. There has been a comprehensive bankruptcy system in place since 1898. Although the Bankruptcy Act had no comprehensive stay provision taking effect automatically upon the filing of a bankruptcy petition,[233] the Act did have provisions for automatic stays in Chapter X[234] and Chapter XII,[235] and in other proceedings the debtor or trustee could request that the court grant a stay.[236] It was only with the promulgation of the Rules of Bankruptcy Procedure in 1973 that an automatic stay was introduced into the more commonly used bankruptcy chapters.[237] The Bankruptcy Reform Act of 1978 made the automatic stay applicable in all types of bankruptcy proceedings.[238] Therefore, there is probably more historical precedent for the automatic stay in bankruptcy than for the delay caused by FIRREA. This would affect investment-backed expectations, making it less likely that the delay of the automatic stay would be considered a taking. Therefore, only the most extraordinary case of delay for a secured creditor could constitute a taking.[239]

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231. *See supra* note 124 and accompanying text.

232. 19 F.3d at 224.

233. *See* James J. White, *The Recent Erosion of the Secured Creditor's Rights Through Cases, Rules and Statutory Changes in Bankruptcy Law*, 53 MISS. L.J. 389, 397 n.29 (1983).

234. *See* Bankruptcy Act of 1898, ch. 541, §§ 141, 30 Stat. 544 (as amended 1938) *repealed by* Act of Nov. 6, 1978, P.L. No. 95-598, § 401, 92 Stat. 2682.

235. *See* Bankruptcy Act of 1898, ch. 541, § 428, 30 Stat. 544 (as amended 1938) *repealed by* Act of Nov. 6, 1978, P.L. No. 95-598, § 401, 92 Stat. 2682.

236. *See* 11 U.S.C. §§ 205(j), 403(c), 513, 516(4), 714, 1016; While, *supra* note 233, at 397 n.29.

237. *See* Bankruptcy Rule 11-44.

238. Bankruptcy Reform Act of 1978, P.L. No. 95-598, § 362, 92 Stat. 2549, 2570 (1978) (codified as amended at 11 U.S. § 362(a) (1994)).

239. The National Bankruptcy Review Commission addressed concerns over the delay experienced by secured creditors in single asset real estate cases, although not expressed in terms of a takings issue. NAT'L BANKR. REV. COMM'N, BANKRUPTCY: THE NEXT TWENTY YEARS, FINAL REPORT 661-65 (1997). The Commission recommended that the $4 million cap in the definition of a single asset real estate case be eliminated, that a plan must be filed or payments commenced within 90 days after the date of the bankruptcy petition or within "30 days after the court

2. Lien Avoidance Provisions

Despite the general deference to property rights in bankruptcy, a trustee may in certain circumstances avoid transfers of property rights, including security interests, bringing property of third parties into the bankruptcy estate or freeing encumbered property. Therefore, under certain circumstances, a secured creditor may lose a security interest entirely in bankruptcy law and be left with only an unsecured claim. Although lien avoidance provisions have been challenged on the basis that they take the property rights of secured creditors without just compensation, the provisions have been upheld against constitutional challenge.

Some of the avoidance provisions fall generally along the lines of state law. For example, section 544(a) permits a trustee to avoid property transfers that could be avoided by a judicial lien creditor, a creditor who has obtained an execution against the debtor, or a bona fide purchaser from the debtor.[240] This section relies entirely upon state law to determine which interests the trustee may avoid and has been upheld against constitutional challenge on that basis.[241] State law provides a procedure for perfecting a security interest by taking certain steps, such as recording or filing, generally designed to give notice of the interest to third parties.[242] Recordation of mortgages dates back to the colonies,[243] so the concept of perfection, although primarily embodied in legislation, could certainly be considered a "background principal of property law," which defines the

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determines" that the single asset real estate provisions are applicable, and that payments required under the section be based upon the "nondefault contract rate" of interest rather than upon the fair market rate. *Id.* at 32-33, 664. In addition, the Commission recommended limitations on the ability of a single asset real estate debtor to confirm a plan that would strip down the secured creditor's claim to the value of property using the new value exception to the absolute priority rule. *See id.* at 34, 665. The Commission's recommendation would require that new value contributed reduce the amount of the secured claim to no more than 80% of the value of the property. *See id.* at 73, 665. Therefore, the Commission's recommendations, if adopted, would further limit the delay allowed in certain cases and would increase the amount paid to the secured creditor in such cases. The recommendations would give additional protection to the property rights of real property secured creditors and would therefore make a successful takings claim less likely.

240. *See* 11 U.S.C. § 544(a) (1994).

241. *See generally* Pirsig Farms, Inc. v. John Deere Co. (*In re* Pirsig Farms, Inc.), 46 B.R. 237, 244 (1985) ("Deere's failure to perfect its liens, not section 544(a) caused Deere to lose its security interests."); Washburn & Roberts, Inc. v. Park East (*In re* Washburn & Roberts, Inc.), 17 B.R. 305, 308 (Bankr. E.D. Wash. 1982) ("[T]he enactment did not divest the defendants of the property, but rather the divestiture is occasioned by their failure to record the deed.").

242. *See, e.g.*, Washburn & Roberts, 17 B.R. at 307 (noting that under Washington state law, a conveyance of property to a person is void against subsequent bonafide purchases if an instrument regarding the conveyance is not duly recorded).

243. *See* JESSE DUKEMINIER & JAMES E. KRIER, PROPERTY 651 (4th ed. 1998).

property interest.[244] In addition, a secured creditor may take whatever steps are required under state law to perfect the security interest and may therefore prevent avoidance under this section. As a result, a secured creditor would have a difficult case showing investment-backed expectations in an unperfected security interest. Therefore, section 544(a) does not present a takings problem.

Section 548 permits a trustee to avoid fraudulent transfers.[245] Although section 548 creates a federal fraudulent transfer law,[246] it is consistent with fraudulent transfer principles under state law.[247] Fraudulent transfer law dates back to the Statute of Elizabeth, adopted in 1570,[248] and should therefore be a background principal defining the interest of a secured creditor. In addition, a secured creditor does not have investment-backed expectations in retaining property transferred by an insolvent debtor.[249] Therefore, section 548 also does not present a takings problem.

Section 522(f)(2) permits the avoidance of non-possessory, non-purchase money liens on household furnishings, appliances, and certain types of exempt property.[250] The property may be exempt under state law or under bankruptcy law. Some courts and commentators have assumed that the Supreme Court upheld the constitutionality of this section, applied prospectively only, in the *Security Industrial* case.[251] However, the Court only addressed the issue of whether the statute was to be applied retroactively, holding that it should not.[252] In the absence of precedent requiring prospective application of bankruptcy legislation, the concurring justices would have found that the section applied retroactively and was constitutional for a number of reasons relating to the specific nature of the security interests invalidated and because the section was limited in its application to only a few types of property.[253] In addition, the affected

244. *See supra* notes 179-85 and accompanying text.

245. 11 U.S.C. § 548(a).

246. *See* BFP v. Resolution Trust Corp., 511 U.S. 531, 535 (1994).

247. *See* Harris & Mooney, *A Property-Based Theory*, *supra* note 2, at 2069 n.142 (comparing § 548's provisions addressing actual fraud and constructive fraud with the Uniform Fraudulent Conveyance Act §§ 4-7, 7A U.L.A. 504-09 (1918) and the Uniform Fraudulent Transfer Act §§ 4(a) & 5(a), 7A U.L.A. 652, 653, 657 (1984)).

248. *See* Hartvig v. Tri-City Baptist Temple (*In re* Gomes), 219 B.R. 286, 297 (Bankr. D. OR. 1998).

249. *See id.* at 288.

250. 11 U.S.C. § 522(f)(2).

251. *See, e.g., In re* Thompson, 867 F.2d 416, 422 (7th Cir. 1989); United States v. Security Indus. Bank, 459 U.S. 70 (1982).

252. The plaintiffs in the case were holders of security interests that were created prior to the passage of the Bankruptcy Reform Act. *See supra* note 127 and accompanying text.

253. *See Security Indus. Bank*, 459 U.S. at 84. The complete list of reasons the concurring justices gave for finding the provision constitutional, even applied retroactively, are as follows:

security interests "have little direct value and weight in [their] own right and [appear] useful mainly as a convenient tool with which to threaten the debtor . . . ."[254] These are the very reasons that the section is constitutional when applied prospectively.

Section 522(f)(1) provides for the avoidance of judicial liens to the extent they impair an exemption to which a debtor would otherwise be entitled.[255] A recent challenge to the constitutionality of section 522(f)(1) was rejected by the First Circuit Court of Appeals.[256] The First Circuit adopted Professor Rogers' reasoning in upholding the validity of the section, finding that the creditor's "property rights in the lien are circumscribed by the debtor's ability under the Code to avoid the lien."[257] Although the court's reasoning is faulty, the result is correct. First, an owner of property has no strand in the bundle of property rights regarding the attachment of a judicial lien to property. A creditor would not have sufficient investment-backed expectations in a judicial lien. The judicial lien creditor's "investment" in the lien is presumably only the cost of the lawsuit required to obtain it. In addition, the reach of section 522(f)(1) is limited, applying only to property that is exempt.[258] Therefore, the section should withstand constitutional challenge.

Only the avoidance of preferences under section 547 is based purely on bankruptcy rather than state law principles.[259] Section 547(b) provides that

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> because the exemptions in question are limited as to kinds of property and as to values; because the amount loaned has little or no relationship to the value of the property; because these asserted lien interests come close to being contracts of adhesion; because repossessions by small loan companies in this kind of situation are rare; because the purpose of the statute is salutary and is to give the debtor a fresh start with a minimum for necessities; because there has been creditor abuse; because Congress merely has adjusted priorities, and has not taken for the Government's use or for public use; because the exemption provisions in question affect the remedy and not the debt; because the security interest seems to have little direct value and weight in its own right and appears useful mainly as a convenient tool with which to threaten the debtor to reaffirm the underlying obligation; because the statute is essentially economic regulation and insubstantial at that; and because there is an element of precedent favorable to the debtor to be found in such cases as Penn Central . . . .

Id.

254. *Id.* For this very reason, the Federal Trade Commission has a credit practices rule prohibiting creditors from taking a non-possessory, non-purchase money security interest in household goods. *See* 16 C.F.R. § 444.2(a)(4) (1999).

255. 11 U.S.C. § 522(f)(1).

256. *See* Patriot Portfolio, LLC v. Weinstein (*In re* Weinstein), 164 F.3d 677, 679 (1st Cir. 1999).

257. *Id.* at 686.

258. 11 U.S.C. § 522(f)(1).

259. *See* Harris & Mooney, *A Property-Based Theory*, *supra* note 2, at 2069.

the trustee may avoid certain transfers of property made to creditors within ninety days before bankruptcy in payment of an antecedent debt.[260] The Sixth Circuit upheld that section against a takings challenge on the basis of notice.[261] While the court's explanation was overly simplified, the result is correct. Because one requirement of the preference provision is that no new value be given, it is difficult to argue that a creditor's expectations in receiving a preferential transfer were "investment-backed." In addition, section 547(b) was a successor to a provision of the Bankruptcy Act which, although slightly different, had similar requirements.[262] Therefore, the section should not present a takings problem.

In summary, I believe a successful takings claim based on current bankruptcy law is unlikely. The authors of the Bankruptcy Code considered the Fifth Amendment in drafting it. The Code gives a great deal of respect to property interests, including those of secured creditors. Lien avoidance provisions have been upheld against constitutional challenge, and only the most extraordinary case of delay might result in a successful takings claim.

B. *Prospective Invalidation of Security Interests*

Although current bankruptcy law protects security interests except in certain narrow circumstances, recent proposals by some scholars would give far less protection to the property rights of secured creditors than they currently enjoy.[263] Based on Professor Rogers' reasoning, a number of scholars have posited that prospective legislation completely invalidating security interests in bankruptcy would not run afoul of the Takings Clause.[264] Therefore, I will now explore the constitutionality of

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260. *See* 11 U.S.C. § 547(b).

261. *See* Hertzberg v. H. Hirschfield & Sons (*In re* Caro Products, Inc.), 746 F.2d 349, 351 (6th Cir. 1984).

262. *See* 11 U.S.C. § 96 (1946) (repealed). One major difference between the old and new preference provisions was that the old provision required that the creditor have "reasonable cause to believe that the debtor [was] insolvent." *Id.*

263. *See, e.g.*, Bebchuk & Fried, *The Uneasy Case*, *supra* note 2, at 904; LoPucki, *supra* note 1, at 1963.

264. *See* Baird & Jackson, *supra* note 15, at 100 ("Congress, acting prospectively, probably could refuse to recognize the rights of secured creditors altogether."); Carlson, *supra* note 15, at 585-86 ("There is little doubt that Congress can adversely affect security interests prospectively, even to the point of banning them altogether."); Eisenberg, *supra* note 15, at 952 n.69 ("Congress probably is free to change prospectively the status of security in bankruptcy, perhaps even to the point of eliminating its priority."); Nickles, *supra* note 154, at 593 (In the "struggle between commercial law and bankruptcy," bankruptcy could "ignore liens altogether in bankruptcy (at least prospectively)."); *see also* Artus v. Alaska Dept. of Labor (*In re* Anchorage Int'l Inn, Inc.), 718 F.2d 1446, 1451 (9th Cir. 1983) ("Congress has the authority to make uniform laws governing the subject of bankruptcies, and, pursuant to that authority, might invalidate in bankruptcy any or all pre-bankruptcy entitlements encumbering the debtor's assets.") (citations omitted).

hypothetical bankruptcy legislation that would completely invalidate security interests in bankruptcy on a prospective basis.[265]

The prospective nature of this hypothetical bankruptcy legislation is crucial to the discussion. Retroactive invalidation of all security interests in bankruptcy would most certainly be a taking of property rights.[266] The Supreme Court did not decide the takings issue in *Security Industrial*, but did find "substantial doubt" about the constitutionality of retroactive application of a provision that invalidates certain types of liens in certain types of collateral.[267] The Supreme Court found a taking in *Armstrong v. United States*, a case in which the government took possession of unfinished navy boats after default by the prime contractor and thus prohibited materialmen from enforcing their liens.[268] The Court held that the "total destruction by the Government of all value of these liens, which constitute compensable property, has every possible element of a Fifth Amendment 'taking' and is not a mere 'consequential incidence' of a valid regulatory measure."[269] Therefore, a government destruction of all compensable value of existing security interests in bankruptcy would similarly constitute a taking.

Prospective legislation, however, can be viewed differently. Professor Rogers argued that prospective legislation by definition does not affect security interests in existence at the time of passage of the legislation and that any security interest created after passage would be created subject to and defined by bankruptcy law then in effect.[270] The legislation, however, would affect owners of property at the time of its passage by restricting their ability to create a security interest that could survive bankruptcy.[271] The two parties potentially in a position to complain about the legislation would be property owners who might desire to create security interests and owners of security interests created after the passage of the legislation. Therefore, the issue must be discussed from both points of view—that of the property owner at the time the legislation is passed and that of the owner of a security interest conveyed after passage of the legislation.[272]

265. I will sometimes refer to this hypothetical legislation as the invalidation proposal.

266. The Court has held on a number of occasions that even small property interests are entitled to Fifth Amendment protection. *See* United States v. Security Indus. Bank, 459 U.S. 70, 76 (1982); Loretto v. Teleprompter Manhattan CATV Corp., 458 U.S. 419, 421 (1982). *See generally* LAITOS, *supra* note 22, part V (discussing retroactivity in the takings context).

267. 459 U.S. at 78.

268. 364 U.S. 40, 41 (1968).

269. *Id.* at 48, *quoted in Security Indus.*, 459 U.S. at 77.

270. *See* Rogers, *supra* note 6, at 987.

271. *See* Bebchuk & Fried, *Further Thoughts*, *supra* note 2, at 1290-91.

272. *See id.* at 1290.

1. Property Owner's Perspective

All property owners would be affected by legislation that invalidated security interests in bankruptcy. Such legislation would limit the right of property owners to alienate their property. In particular, property owners would be unable to transfer a security interest that could survive a bankruptcy filing. The question then is whether an owner's ability to create a security interest is such an important property right that a restriction thereon can be a taking. Professor Rogers completely ignored this issue in his analysis, focusing only on the effects of prospective legislation on secured creditors.[273]

The Supreme Court has held that the taking of one strand of an owner's bundle of property rights can, under some circumstances, violate the Takings Clause.[274] However, not all strands in the bundle are sufficiently important. In *Andrus v. Allard*,[275] the Supreme Court considered the constitutionality of federal statutes and regulations that prohibited the sale of Indian artifacts made with feathers from eagles and other protected birds.[276] The Court first held that the statutes and regulations prohibited the sale of artifacts made with feathers obtained legally before the statutes were adopted.[277] The Court then upheld the statutes and regulations, stating that "the denial of one traditional property right does not always amount to a taking."[278] The Court found it crucial that the owners of the artifacts retained "the rights to possess and transport their property, and to donate or devise the protected birds."[279]

Later in the same term, the Court decided another case involving one right in the bundle of sticks, holding that a taking of the right to exclude others from a part of a landowner's property required compensation. *Kaiser Aetna v. United States*[280] involved a developer who had dredged a channel between Kuapa Pond, a private pond on its land, and Maunalau Bay in order to create a private marina with access to the Pacific Ocean.[281] The Corps of Engineers claimed that the pond had become a navigable

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273. *See* Rogers, *supra* note 6.

274. Professor Mandelker calls this functional segmentation. *See* Daniel R. Mandelker, *New Property Rights Under the Taking Clause*, 81 MARQ. L. REV. 9, 12 (1997). "Functional segmentation occurs when government intervention or regulation segments intangible, nonpossessory property rights." *Id.*

275. 444 U.S. 51 (1979).

276. *See id.* at 53-54.

277. *See id.* at 63.

278. *Id.* at 65.

279. *Id.* at 66.

280. 444 U.S. 164 (1979).

281. *See id.* at 167.

waterway and that the public could not be denied access.[282] The Court held that the government could not require public access without compensation.[283] The Court said that the right to exclude was "one of the most essential sticks in the bundle of rights that are commonly characterized as property."[284]

More recently, the Court addressed the constitutionality of a statute which abolished the rights of descent and devise for a particular class of property without compensation in *Hodel v. Irving*.[285] The Indian Land Consolidation Act of 1983[286] provided that certain small fractional interests in tribal land could not pass by intestacy or devise but would escheat to the tribe. The statute did not provide for compensation to the owners of these interests that would escheat.[287] The suit was brought by parties who would have inherited interests in tribal land, but on behalf of the decedents.[288] Therefore, the issue was whether the statute, by completely destroying the right to transfer by descent or devise, violated the Takings Clause.[289] The Court held that it did.[290]

Ten years later, the Court addressed the constitutionality of an amended version of the same statute in *Babbitt v. Youpee*.[291] The amended statute permitted the devise of interests that would otherwise escheat to parties already owning an interest in the same parcel.[292] Justice Stevens argued that the decedent, with notice of the statute for more than seven years before his death, "could have realized the value of his fractional interests . . . in a variety of ways, including selling the property, giving it to his children as a gift, or putting it in trust for them."[293] The majority focused on the limitations on his right to devise, even after the amendment of the statute, stating that "[a]llowing a decedent to leave an interest only to a current owner in the same parcel shrinks drastically the universe of possible successors."[294] Therefore, the Court found that the amendment of

282. *See id.* at 168.
283. *See id.* at 179-80.
284. *Id.* at 176.
285. 481 U.S. 704, 706 (1987).
286. Pub. L. No. 97-459, Tit. II, 96 Stat. 2519, § 207 (1983).
287. *See Irving*, 481 U.S. at 709.
288. *See id.* at 711.
289. *See id.* at 706.
290. *See id.* at 717.
291. 519 U.S. 234, 236 (1997).
292. *See id.* at 241. Other revisions changed the formula for determining which interests were escheatable interests and gave tribes the right to override the statute with their own schemes for consolidation of the interests. *See id.*
293. *Id.* at 247 (Stevens, J., dissenting).
294. *Id.* at 244-45.

the statute did not eliminate the takings problem.[295]

The Court's holding in *Irving* was unanimous, but the justices disagreed over the effect of the decision on *Andrus*.[296] Three of the justices felt that *Andrus* was not limited and that the issues in the *Irving* case were unusual.[297] Three other justices felt that *Andrus* had been limited to its facts.[298] In *Andrus*, the Court had made clear that not all rights in the bundle of property rights are so important that a taking of one strand will require compensation.[299] In *Kaiser Aetna* and *Irving*, the Court made clear that some rights in the bundle are that important.[300] The question then is whether the ability to create a security interest is such a fundamental strand in the bundle of rights.

The invalidation of security interests in bankruptcy would not prohibit the creation of a security interest, but would eliminate an owner's ability to create a security interest that could survive a bankruptcy filing. This could, in and of itself, constitute a taking. In *Irving*, the Court found relevant that the right to pass property to one's family "has been part of the Anglo-American legal system since feudal times."[301] The right to grant a security interest, at least in real property, has been part of the Anglo-American legal system since before feudal times.[302] Thus, the invalidation proposal could be a taking because of limitations it would impose on a property owner's right to create a security interest.

In addition, the invalidation proposal could, as a practical matter, limit the availability of secured credit.[303] Limitations on the availability of secured credit could have a substantial effect on the ability of property owners to transfer those types of property which traditionally have required

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295. *See id.*

296. *Irving*, 481 U.S. at 718.

297. *See id.* (Brennan, Marshall & Blackman, J.J., concurring).

298. *See id.* at 719 (Scalia & Powell, J.J. & Rehnquist, C.J., concurring).

299. 444 U.S. 51, 66 (1979).

300. *See Irving*, 481 U.S. at 715-717; *Kaiser Aetna*, 444 U.S. at 164-65.

301. *Irving*, 481 U.S. at 716.

302. *See* Kratovil, *supra* note 165, at 1 ("[M]ortgage arrangements of various kinds existed even in the Anglo-Saxon times before the conquest of England by William the Conqueror in 1066 A.D.").

303. Congress has considered before the effect that bankruptcy limitations on the rights of secured creditors would have on the availability of secured credit. *See, e.g., Bankruptcy Reform Act of 1978: Hearings on S. 2266 and H.R. 8200 Before the Subcomm. on Improvements in Judicial Machinery of the Senate Comm. on the Judiciary*, 95th Cong., 1st Sess. 707, 714 (1977) (statement of Edward J. Kulik, Senior Vice President, Real Est. Div., Mass. Mut. Life Ins. Co.), 715 (statement of Robert E. O'Malley, attorney, Covington & Burling) (expressing concern that permitting modification of home mortgage loans in Chapter 13 would have a negative impact on the availability of home mortgage credit); Conference Report, June 18, 1934, 73rd Cong. 2nd Sess., 78 Cong. Rec. 12,074 (statement of Senator Bankhead), 12,075 (statement of Senator Fess), 12,137 (statement of Representative Peyser) (evidencing concern that applying the Frazier-Lemke Act to future mortgages would make it impossible for farmers to borrow).

secured financing for purchase—primarily land. If secured financing or some substitute were not available, some land transfers might not occur at all. Although the Supreme Court held that prohibition on transfer of Indian artifacts made with feathers was not a taking, it is difficult to believe that a substantial limitation on transfer of land would be similarly viewed.[304] Therefore, whether the measure would constitute a taking would depend not only upon the importance of the right to grant a security interest, but also upon the extent to which it interfered with a property owner's right to transfer property. If the proposal interfered substantially with the right to transfer land, it would be an unconstitutional taking.

2. Secured Creditor's Perspective

a. Applying the Takings Formula

Even if the proposal is not a taking from the property owner's point of view, it could still be a taking from the secured creditor's point of view. With prospective legislation, the secured creditor would take the security interest with notice of bankruptcy law in place on the date of the creation of the interest. The issue then is the effect of that notice. To understand the relevance of retroactivity in takings jurisprudence, it is necessary to understand where the notice factor fits into the takings formula. There are two places where it could fit. First, a prospective statute may define the property interest itself. This is the approach that Professor Rogers took.[305] He assumed that the property interest of a secured creditor is defined by bankruptcy law, including recent changes, as well as by state law.[306] Second, the prospective nature of a statute may be tied to the takings formula because of the factor of investment-backed expectations. If a property owner knows of limitations affecting a property interest, then the owner's investment-backed expectations in that property are limited. This is the approach of the Supreme Court in the *Monsanto* case discussed

304. *See Andrus*, 444 U.S. at 67-68. Justice Scalia, in the *Lucas* opinion, indicated that regulations affecting land should be examined more strenuously than regulations affecting personal property. *See* 505 U.S. 1003, 1027-28 (1992); *see also* Fred P. Bosselman, *Scalia on Land*, *in* AFTER *LUCAS:* LAND USE REGULATION AND THE TAKING OF PROPERTY WITHOUT COMPENSATION (David L. Callies ed. 1993).

305. *See* Rogers, *supra* note 6, at 987.

306. *See id.* at 986-88. Rogers says "the proposition that the fifth amendment imposes limitation on even purely prospective restriction of the rights of secured creditors seems to assume that the property rights held by secured creditors are in some sense anterior to positive law." *Id.* at 987; *see also* Carlson, *supra* note 15, at 585-86 (stating that security interests become property interests by definition when Congress prospectively bans them on some exempt consumer goods).

below[307] and of other courts that apply a notice rule in takings.[308]

The Supreme Court has rejected Professor Rogers' approach to defining property rights, holding that the extent of a property interest is determined by "background principles of property law."[309] Even if the concept of background principles of property law does encompass federal legislation as well as state common law, the invalidation proposal would not be a background principle. Bankruptcy law gives great deference to security interests and to other property rights both traditionally and currently.[310] Therefore, newly enacted bankruptcy legislation would not redefine the property rights of secured creditors.

If a newly enacted statute does not define the property interest, then notice of the statute may fit into the takings formula only through the investment-backed expectations factor. However, investment-backed expectations are a factor in the takings formula only if there is a regulatory taking that is not a categorical taking. A categorical taking occurs if regulation requires a physical invasion of property[311] or if a regulation denies all economically beneficial use of land.[312] There is certainly no physical invasion of property raised by the invalidation proposal. There may be a denial of all economically beneficial use of property if this categorical taking is not limited in its application to land[313] since the entire interest of the secured creditor is taken.[314]

More convincing is an argument that the invalidation proposal is not a regulatory taking at all but rather an appropriation or destruction of property.[315] The Supreme Court acknowledged in *Security Industrial* that

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307. *See infra* notes 326-34 and accompanying text.

308. *See infra* note 324.

309. *See supra* notes 179-82 and accompanying text.

310. *See supra* notes 32, 49-53 and accompanying text.

311. The Supreme Court has held that a physical invasion of property, no matter how small, constitutes a taking. *See* Loretto v. Teleprompter Manhattan CATV Corp., 458 U.S. 419, 421 (1982).

312. *See supra* note 77 and accompanying text.

313. In *Lucas*, Justice Scalia said that a categorical taking resulted when a regulation led to denial of all economically beneficial use of land. 505 U.S. at 1015.

314. Whether there has been a denial of all economically beneficial use depends upon the resolution of what is commonly known as the "denominator problem." Justice Scalia mentioned the denominator problem in footnote 7 in the *Lucas* opinion, but did not offer a solution as it was not an issue in that case. 505 U.S. at 1018 n.7. The issue raised by the denominator problem is just what is the unit of property to be used in determining whether a regulation denies all economically beneficial use of property. *See infra* notes 355-56 and accompanying text, discussing the segmentation issue, which is related to the denominator problem.

315. In a Chapter 7 bankruptcy, the sale of assets is conducted by a trustee. If the trustee were to sell property free and clear of a lien, then were to transfer proceeds of the sale pro rata to all of the debtor's creditors, there is an appropriation. If a Chapter 11 or Chapter 13 debtor keeps property free of a lien, with no obligation on the part of the debtor to pay the value of the property to the

"a complete destruction of the right of the secured party . . . fits but awkwardly into the analytic framework employed in [regulatory takings cases]."[316] In *Phillips*, the Court distinguished "confiscatory regulations" from "those regulating the use of property."[317] The invalidation proposal is confiscatory rather than regulatory from the secured creditor's perspective.[318] The fact that the interest is appropriated for the benefit of parties other than the government does not make it any less an appropriation.[319] Therefore, a strong argument exists that a court would never reach the ad hoc test, which requires a consideration of investment-backed expectations, and would thus find that the invalidation proposal is a confiscatory taking.

If the ad hoc test does apply, then it could be applied as follows. First, the economic impact of the invalidation proposal upon the holder of a security interest would be substantial. The secured creditor would be treated the same as unsecured creditors in the bankruptcy. If there were large unsecured claims, then the secured creditor like most unsecured creditors in bankruptcy might receive only cents on the dollar for the claim. Second, the character of the government regulation is, as in *Irving*, extraordinary. The security interest would be abrogated in its entirety. Finally, reasonable investment-backed expectations are arguably not very high. The secured creditor would have actual or constructive notice of the invalidation of the security interest in the event of a bankruptcy. Whether the invalidation proposal would withstand constitutional scrutiny under the ad hoc test depends on the effect of this factor in the balancing test. Therefore, more discussion of reasonable investment-backed expectations is necessary.

b. Reasonable Investment-Backed Expectations

The reasonable investment-backed expectations factor originated in an article published in 1967 by Professor Frank Michelman.[320] Justice Brennan adopted "distinct investment-backed expectations" as one of three factors in the takings formula enunciated in *Penn Central Transportation*

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secured creditor, there is a destruction.

316. 459 U.S. 70, 75 (citations omitted).

317. 118 S. Ct. 1925, 1931 (1998). "[A]t least as to confiscatory regulations (as opposed to those regulating the use of property), a State may not sidestep the Takings Clause by disavowing traditional property interests long recognized under state law." *Id.*

318. *See infra* notes 387-90 and accompanying text.

319. *See* Eastern Enters. v. Apfel, 118 S. Ct. 2131, 2146 (1998).

320. *See* Frank I. Michelman, *Property, Utility, and Fairness: Comments on the Ethical Foundations of "Just Compensation" Law*, 80 HARV. L. REV. 1165, 1166 (1967); *see also* Robert M. Washburn, *"Reasonable Investment-Backed Expectations" As a Factor in Defining Property Interests*, 49 WASH. U. J. URB. & CONTEMP. L. 63 (1996) (discussing the origin of the phrase).

Co. v. New York City.[321] Later, the court began using the language "reasonable investment-backed expectations,"[322] and has continued using this language.[323] In this section I will discuss the effect of investment-backed expectations in the context of the invalidation proposal.

Some courts and commentators treat the reasonable investment-backed expectations factor as encompassing a notice rule.[324] The argument is that when a party purchases property with notice of regulations affecting the property, the purchaser has no reasonable investment-backed expectations with respect to the interest in the property affected by the regulations. This lack of reasonable investment-backed expectations arguably precludes a finding that property rights have been taken. Although some courts have adopted a notice rule in takings cases, the Supreme Court has rejected a strict notice rule.[325]

In *Ruckelshaus v. Monsanto Co.*[326] the Court seemed to adopt a notice rule based on the reasonable investment-backed expectations requirement. *Monsanto* involved the constitutionality of federal legislation that authorized the EPA to use data submitted by a pesticide registration applicant to evaluate subsequent applications and authorizing the EPA to disclose some data to the public.[327] Monsanto argued that the use and disclosure of trade secrets constituted a taking of property without just compensation.[328] The Court first determined that Monsanto did have a property interest in the data it had submitted to the EPA.[329] In determining whether a taking had occurred, the Court focused on the reasonable investment-backed expectations factor.[330] The Court held:

> Monsanto could not have had a reasonable, investment-backed expectation that EPA would keep the data confidential beyond the limits prescribed in the amended statute itself. Monsanto was on notice of the manner in which EPA was authorized to use and disclose any data turned over to it by an applicant for registration.[331]

321. *See* 438 U.S. 104, 124 (1978).

322. Kaiser Aetna v. United States, 444 U.S. 164, 175 (1979).

323. *See, e.g.*, Eastern Enters. v. Apfel, 118 S. Ct. 2131, 2146 (1998); Hodel v. Irving, 481 U.S. 704, 714 (1987); Ruckelshaus v. Monsanto Co., 467 U.S. 986, 1005 (1984); Pruneyard Shopping Center v. Robins, 447 U.S. 74, 83 (1980) (citing *Kaiser Aetna*, 444 U.S. at 175).

324. *See* Anello v. Zoning Board of Appeals, 678 N.E.2d 870, 871 (N.Y.), *cert. denied*, 118 S. Ct. 2 (1997); Grant v. South Carolina Coastal Council, 461 S.E.2d 388, 391 (S.C. 1995).

325. *See infra* notes 335-42 and accompanying text.

326. 467 U.S. 986 (1984).

327. *See id.* at 990.

328. *See id.* at 998-99.

329. *See id.* at 1003-04.

330. *See id.*

331. *Id.* at 1006.

The Court went on to stress that the sale and use of pesticides had long been a source of public concern and a subject of governmental regulation.[332] Monsanto had a reasonable investment-backed expectation only for the period during which the government had explicitly provided for confidentiality.[333] Therefore, the Court's interpretation of the reasonable investment-backed expectations factor was tied substantially to the question of notice. After the Court's holding in *Monsanto*, lower courts relied on *Monsanto* as the basis of a notice rule in takings cases.[334]

However, the Court rejected a notice rule three years later in *Nollan v. California Coastal Commission*.[335] In *Nollan*, the Court found a taking when the California Coastal Commission required a public access easement as a condition to granting a permit to the Nollans to build a new home on their beachfront property.[336] Justice Brennan, in his dissenting opinion, argued that there was no taking because the Nollans purchased the property with notice of regulation of development and with notice that the access easement condition had been imposed on other development projects.[337] As a result, Justice Brennan would have held that the Nollans did not have reasonable investment-backed expectations in the right to develop their property.[338]

The majority of the Court, in an opinion by Justice Scalia, rejected Justice Brennan's application of a notice rule to the case and distinguished the case from *Monsanto*.[339] The Court limited the holding in *Monsanto* to cases involving "the right to [a] valuable Government benefit,"[340] and found that the right to build on property was not a government benefit.[341] The Court went on to state:

> Nor are the Nollans' rights altered because they acquired the land well after the Commission had begun to implement its policy. So long as the Commission could not have deprived the prior owners of the easement without compensating them, the prior owners must be understood to have transferred their

332. *See id.* at 1007.
333. *See id.* at 1011.
334. *See* Daniel R. Mandelker, *Investment-Backed Expectations in Takings Law*, 27 URB. LAW. 215, 219 (1995); *see, e.g.*, Furey v. City of Sacramento, 592 F. Supp. 463, 470 (E.D. Cal. 1984), *aff'd on other grounds*, 780 F.2d 1448 (9th Cir. 1986).
335. 483 U.S. 825, 835-42 (1987).
336. *See id.* at 337.
337. *See id.* at 859.
338. *See id.* at 860.
339. *See id.* at 833 n.2.
340. *Id.* (quoting *Monsanto*, 467 U.S. at 1007).
341. *See id.* at 834 n.2.

full property rights in conveying the lot.[342]

Therefore, the Court rejected a notice rule.

The invalidation proposal can be distinguished from the *Nollan* case on several bases, but none of the distinctions should be the basis for applying a strict notice rule to the invalidation proposal. The first distinction is that *Nollan* involved a physical invasion of real property, and the invalidation proposal does not. "[T]akings problems are more commonly presented when 'the interference with property can be characterized as a physical invasion by government, than when interference arises from some public program adjusting the benefits and burdens of economic life to promote the common good.'"[343] However, economic regulation can be a taking as the Court recently held in *Eastern Enterprises v. Apfel*.[344] In *Eastern Enterprises*, the Court considered the validity of the Coal Industry Retiree Health Benefit Act of 1992,[345] which would have retroactively required Eastern Enterprises to pay $50 to $100 million into a benefit plan for employees the company employed between 1946 and 1965. Because the legislation was retroactive, the Court focused on Eastern's reasonable investment-backed expectations, finding that Eastern could not have had "sufficient notice" that this amount of liability could be imposed several decades after its involvement in the coal industry.[346] Significantly, the legislation struck down in *Eastern Enterprises* did not affect any specific property right or interest but rather created a general liability for the payment of money. The Court had previously refused to find a taking in other cases imposing a general liability even retroactively.[347] The case is important because it illustrates that no one factor in the ad hoc test is determinative, and investment-backed expectations are just one of the three factors to be considered along with the character of the government action and the economic impact. The Court found a taking in *Eastern Enterprises* where the character of the governmental action was an economic regulation creating a general liability.[348] The Court also found a taking in *Nollan* where the character of the governmental action was a physical invasion and there was prior notice of the regulation.[349] The fact that prior notice affects reasonable investment-backed expectations should not preclude a finding

342. *Id.*

343. Eastern Enters. v. Apfel, 118 S. Ct. 2131, 2146 (1998) (quoting Penn Cent. Transp. Co. v. New York City, 438 U.S. 104, 124 (1978)).

344. *Id.*

345. 26 U.S.C. §§ 9701-9722 (1994 Ed. & Supp. II).

346. *See Eastern Enters.*, 118 S. Ct. at 2151-52.

347. *See* Concrete Pipe & Prods. v. Construction Laborers Pension Trust, 508 U.S. 602, 605 (1993); Connolly v. Pension Benefit Guar. Corp., 475 U.S. 211, 228 (1986).

348. 118 S. Ct. at 2161.

349. 483 U.S. 825, 833-34 (1987).

of an unconstitutional taking.

Another distinction that can be drawn between the invalidation proposal and *Nollan* is the type of post-regulation transfer involved. In *Nollan*, the entire fee simple ownership of the land was transferred to the new owners, including the right to bring a takings claim.[350] With respect to the invalidation proposal, only an interest in the property, a security interest, would be transferred with notice. The specific interest transferred is the very interest that would be invalid in bankruptcy under the proposal. This raises the so-called "denominator" and "segmentation" issues. The "denominator" issue involves determining the "'property interest' against which the loss of value is to be measured."[351] The "segmentation" issue arises when only part of an owner's property is conveyed, separating the regulated portion from the unregulated portion.

In *Penn Central Transportation Co. v. New York City*,[352] the Supreme Court held that New York City's landmarks preservation law, which prohibited Penn Central from using the air rights above its terminal, was not a taking. The court considered the three factors that it first enunciated in that case[353] and ultimately determined that Penn Central could still profit from the terminal and receive a reasonable return on its investment without using the air rights. But what if the air rights had been owned separately at the time of regulation or had been conveyed after the regulation was adopted?[354] The conveyance of the regulated portion of the owner's property rights would raise the segmentation issue.

The Federal Circuit Court of Appeals discussed the segmentation problem in *Loveladies Harbor, Inc. v. United States*.[355] In *Loveladies*, a developer sought a permit from the Army Corp of Engineers to fill a 12.5-acre tract for residential development.[356] The developer had originally owned a 250-acre tract acquired in 1958, but 199 of the 250 acres had been developed before the enactment of section 404 of the Clean Water Act.[357] With 51 acres remaining and 50 of those needing to be filled for development, the developer had agreed with the New Jersey Department

350. *See id.* at 826.

351. Lucas v. South Carolina Coastal Council, 505 U.S. 1003, 1016 n.7 (1992).

352. 438 U.S. 104, 138 (1978).

353. *See supra* notes 73-74 and accompanying text.

354. When I teach this case, I always ask my students if it would make a difference if the air rights had been owned by a different party. Students frequently answer that it would, because the owner of the air rights would then have no use whatsoever for them. I next ask whether Penn Central could sell the air rights after the prohibition on their use had been imposed. Most students assume that this would not be an appropriate way for Penn Central to avoid the application of the Supreme Court's holding of no taking.

355. 28 F.3d 1171, 1180 (Fed. Cir. 1994).

356. *See id.* at 1174.

357. *See id.*

of Environmental Protection to dedicate 38.5 of the remaining 51 acres to the state.[358] Since one acre was already filled, the developer sought a permit from the Corps of Engineers to fill 11.5 acres of wetlands.[359] At issue was the relevant parcel for determining whether there had been a taking. The government argued that using the 12.5-acre tract as the relevant denominator parcel "would encourage strategic behavior on the part of developers—'conveying away the non-wetland portions of their parcels prior to applying to the Corps for a permit to fill the remaining wetlands.'"[360] The court, however, considered "the timing of transfers in light of the developing regulatory environment."[361] Because the 199 acres had been developed or sold before the regulatory environment existed and because the 38.5 acres were to be transferred in exchange for the New Jersey Department of Environmental Protection permit, the court concluded that the relevant parcel was the 12.5-acre tract.[362]

The government's concern in *Loveladies* that owners should not be able to sever the very part of the owner's property that is subject to regulation in order to create a takings claim that would not otherwise exist is a valid concern in the context of horizontal segmentation as in *Loveladies*[363] or vertical segmentation as in *Penn Central.*[364] Functional or conceptual segmentation of different strands in the bundle of property rights does not raise the same concern.[365] Secured parties do not take security interests and property owners do not convey them in order to segment the portion of the property subject to regulation. Therefore, the security interests can be treated as a separate property interest for purposes of applying the takings formula without concern over "strategic behavior." This is true even where the secured creditor has notice of the invalidation proposal at the time of the creation of its interest. The question is whether a property owner, who arguably does not have a takings claim based on the inability to create a security interest that could survive bankruptcy,[366] can convey that very interest to a secured creditor and create a takings claim in the secured creditor. However, the secured creditor's notice of the invalidation of the interest in bankruptcy does not encourage the creation of the security interest in order to create a takings claim that would not otherwise exist.

Another potential distinction between the invalidation proposal and

358. *See id.* at 1180.
359. *See id.* at 1174, 1180.
360. *Id.* at 1181.
361. *Id.*
362. *See id.* at 1181, 1183.
363. *See id.* at 1180.
364. *See Penn Central,* 438 U.S. at 131.
365. See *supra* note 274 regarding functional segmentation.
366. *See supra* Part IV.B.1.

Nollan relates to the ripeness problem that arises with transfers of the entire interest of an owner in property. The Supreme Court's apparent reason for disavowing a notice rule in *Nollan* was that the property owners should be treated as having conveyed the entire interest in the property including any takings claims. One criticism of a notice rule is that it would require current owners to assert takings claims or lose them.[367] The Nollan's predecessors had no cause of action against the Coastal Commission because their claim could not be ripe until they pursued a development plan. If a sale of the property would destroy any possibility of a claim, then landowners would be forced to make their claims ripe or lose them upon a sale of the property.

The ripeness problem also arises with respect to the invalidation proposal, but in a different way. A secured creditor whose security interest was created after adoption of the invalidation proposal would not have a takings claim at the time the security interest was created based only on the risk of the loss of that interest in the event of a bankruptcy. The secured creditor's claim could only arise if a bankruptcy did occur, thus invalidating the security interest. The taking, if any, would occur only when the security interest was destroyed.

The problem with the notice rule as applied to the invalidation proposal is that the secured creditor has notice only of a risk of bankruptcy, not of a certainty. Professor Mandelker has discussed the relationship between notice and reasonable investment-backed expectations in the context of regulatory risk.[368] He refers to situations where regulations change, but also to situations where there is uncertainty about whether the government will grant a needed permit. He concludes: "Courts should recognize landowner expectations when risks are minimal. They should refuse to recognize landowner expectations when risks are high."[369]

Some of Professor Mandelker's ideas regarding regulatory risk can be applied in the context of bankruptcy risk. Depending upon the financial stability of the debtor, the risk of bankruptcy may be relatively low. However, under the invalidation proposal, the secured creditor's loss in the event of bankruptcy is very high. Thus, in most circumstances, bankruptcy is a low-probability, high-loss event. Empirical research indicates that for various reasons, people tend to underestimate the likelihood of the occurrence of low-probability, high-loss events.[370] Therefore, a secured

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367. *See* Steven J. Eagle, *The 1997 Regulatory Takings Quartet: Retreating From the "Rule of Law,"* 42 N.Y.L. SCH. L. REV. 345, 368-69 (1998).

368. *See* Mandelker, *supra* note 334, at 240-43.

369. *Id.*

370. *See* KENNETH S. ABRAHAM, DISTRIBUTING RISK 22 (1986); HOWARD KUNREUTHER, DISASTER INSURANCE PROTECTION 185-86 (1978); Julia Patterson Forrester, *Mortgaging the American Dream: A Critical Evaluation of the Federal Government's Promotion of Home Equity*

creditor may actually underestimate the risk of bankruptcy.[371]

Of course, large institutional lenders with many secured loans outstanding should be able to calculate the probability and risk of bankruptcy and increase their interest rates accordingly.[372] These types of lenders might not have reasonable investment-backed expectations in their security interests that could make a takings claim successful in the event of a bankruptcy.[373] It is more likely that an individual or one-time secured creditor could have reasonable investment-backed expectations regarding the low risk of bankruptcy. A one-time secured creditor might have a perfectly reasonable but unrealistic view of the probability of bankruptcy.[374] In addition, the secured creditor might have only constructive notice rather than actual notice of the statute itself.

Whether notice is actual or constructive is relevant in determining the extent of reasonable investment-backed expectations. The Court of Federal Claims has discussed the difference between actual and constructive notice in the context of whether a property owner is reasonable in his expectations in *Bowles v. United States*.[375] In that case Bowles purchased a residential lot without actual notice that he would be required to obtain a permit from the Army Corps of Engineers in order to fill his lot for development.[376] Surrounding lots had been filled and developed without obtaining a permit.[377] The court said:

> When the land owner has actual knowledge of the government regulation prior to purchase, the "notice" defense

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Financing, 69 TUL. L. REV. 373, 383-85 (1994); Paul Slovic et al., *Preference for Insuring Against Probable Small Losses: Insurance Implications*, 44 J. RISK ASSESSMENT 237, 253 (1977); Neil D. Weinstein et al., *Promoting Remedial Response to the Risk of Radon: Are Information Campaigns Enough?*, 14 SCI. TECH. & HUM. VALUES 360, 370 (1989). *But see* Roger G. Noll & James E. Krier, *Some Implications of Cognitive Psychology for Risk Regulation*, 19 J. LEGAL STUD. 747, 755 (1990) ("[P]eople behave as if they think that low-probability events are more likely than their own beliefs about the probabilities would suggest. . . ."). The results of various studies show that people buy more insurance against moderate- or high-probability, low-loss events than against low-probability, high-loss events. *See* Slovic, *supra*, at 253.

371. Professor Mann provides casual empirical support for this proposition based on interviews with lending executives at three companies. *See* Ronald J. Mann, *Strategy and Force in the Liquidation of Secured Debt*, 96 MICH. L. REV. 159, 241-43 (1997). The banking executive he interviewed said that loan officers "don't think or give one hoot about bankruptcy/workout scenarios. They hope to hell it won't happen. . . ." *Id.* at 242.

372. *But see id.* at 241-43 (discussing views of lending executives with large institutional lenders).

373. However, it may be improper to consider a lender's entire portfolio of security interests in determining that there are not sufficient investment-backed expectations in one.

374. *See supra* note 370 and accompanying text.

375. 31 Fed. Cl. 37, 51 (1994).

376. *See id.* at 42, 43.

377. *See id.* at 43.

> makes economic sense. A rational buyer who has actual notice of government land-use regulations prior to purchase will consider the risk that use may be restricted when deciding how much to pay. That is, the rational buyer is compensated for this risk up front by purchasing the property at a discount. Though, of course, the seller may have a valid taking claim.[378]

In holding for Bowles, the court noted that a reasonable person would have believed that a permit was not required for building.[379] Therefore, the reasonable belief of a secured creditor about the current state of bankruptcy law as well as about the risk of bankruptcy would be relevant in determining the extent of the secured creditor's investment-backed expectations.

Courts have not elaborated on what makes expectations "investment-backed." But one possibility of the meaning of the term is the ability of the owner to compensate for known limitations with respect to property rights by paying less for the property. If a limitation attaches to particular properties, then purchasers can compensate by paying less for those properties than for properties without similar limitations.[380] Therefore, if a party knew that a property encompassed wetlands and that the government could prohibit development of the wetland areas, that party would pay less for the property than for property without wetlands. The loss of the government regulation would fall on the party that owned the property at the time the regulations were adopted, and the real issue would be the extent of the regulation. Only those secured creditors involved in a large number of transactions would have the ability to compensate for a limitation that affects all security interests but that only causes a loss in the event of some unpredictable future event.[381]

Finally, even if investment-backed expectations are "dubious," it is still possible to find a taking if the other factors are strong enough. The Supreme Court found a taking in *Irving* despite finding the extent of investment-backed expectations to be dubious.[382] Because the Court found the character of the regulation to be extraordinary, the Court found a taking despite the lack of investment-backed expectations.[383] The Court found that "the regulation . . . amounts to virtually the abrogation of the right to pass on a certain type of property—the small undivided interest—to one's

378. *Id.* at 51.

379. *See id.*

380. For example, a purchaser would pay less for property that encompassed wetlands than for property without wetlands.

381. *See supra* notes 373-74 and accompanying text.

382. *Irving*, 481 U.S. at 715.

383. *See id.* at 716.

heirs."[384] The Court went on to say that the right had been part of our legal system since feudal times.[385] *Irving* predated *Lucas*, in which the Court announced that some types of takings were categorical and did not require the consideration of the ad hoc formula.[386] The only consideration of the investment-backed expectations factor in categorical takings, of course, is with respect to background principles of property. Therefore, *Irving* is consistent with *Lucas* if the taking in *Irving* is equivalent to a categorical taking. Where a property interest like a security interest is completely destroyed, especially with respect to real property, it could be treated as equivalent to a categorical taking.

In conclusion, notice is certainly relevant in determining the extent of a secured creditor's reasonable investment-backed expectations. However, the Supreme Court has rejected a strict notice rule that would preclude the finding of a taking in the event a secured creditor had notice of the invalidation of the security interest in the event of bankruptcy. Because of the uncertainty of a bankruptcy, a secured creditor might be reasonable in the expectation of retaining a security interest. In addition, because a secured creditor could not avoid the possibility of losing the security interest by avoiding a particular type of security interest or collateral, the secured creditor might have reasonable investment-backed expectations. Finally, even if the reasonable investment-backed expectations factor is weak, a court could still find an unconstitutional taking based on the strength of the other factors in the formula.

3. Comparing Destruction of Other Property Rights in Bankruptcy

Although the invalidation proposal applies only to invalidate security interests, Congress could conceivably destroy other property rights in bankruptcy. Many of the same types of arguments would arise, so it is useful to explore some of these possibilities. If Congress could prospectively refuse to recognize security interests, then Congress could also refuse prospectively to recognize a tenant's possessory interest under a lease from a bankrupt landlord,[387] the rights of a co-tenant of a bankrupt property owner,[388] the rights of mineral or royalty interests in land owned

384. *Id.*

385. *See id.*

386. *Lucas*, 112 S. Ct. at 2893.

387. In Chapter 7, the trustee would be able to sell the property free and clear of a burdensome lease. In Chapter 11, the debtor in possession would be free to lease the property at market rental rates.

388. Current bankruptcy law permits the property to be sold free and clear of the interest of a co-tenant under certain circumstances if the co-tenant is compensated for the value of the interest, but this proposal would not contemplate compensation.

in fee by a party in bankruptcy, or even the rights of a purchaser of property from a party who is subsequently in bankruptcy.[389] With prospective legislation, these owners of property interests would have notice of the limitation on their interests at the time of the creation of their interests. Arguably, they would have the option to simply avoid acquiring the property interest at all. The only ability that the purchasers of property interests would have to avoid the loss would be to assess the financial stability of the seller of the interest. Otherwise, to the extent the parties needed to lease, own in co-tenancy, own mineral interests, or purchase property, they would be unable to protect themselves from the risk of losing their interests in bankruptcy.

Can a security interest be distinguished from any of these interests? One distinction between a security interest and the interest of a tenant, co-tenant, or purchaser is that a security interest is a non-possessory interest, so there is no physical invasion. But if a security interest really is a property interest, then the loss of a security interest is just as much an appropriation or destruction. The royalty interest, treated as an interest in property in many states,[390] is also a non-possessory interest. Even with notice, the appropriation of non-possessory interests in property, such as security interests and royalty interests, seems to cross the line and go "too far." Therefore, a court should find an unconstitutional taking even with respect to the prospective appropriation of an interest in property.

4. Distinguishing Lien Avoidance and Lien Priority Provisions

Scholars have assumed that because current law imposes limitations on the rights of secured creditors, additional or different limitations on their rights would not create a takings problem.[391] For example, they could argue that if liens can be avoided in bankruptcy, they can be ignored altogether. However, the takings determination is an ad hoc determination that

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389. This would permit property previously sold by a debtor to be brought back into the bankruptcy estate free and clear of the interest of the purchaser. As preposterous as this sounds as an actual amendment to bankruptcy law, it illustrates an argument made by Professors Steven Harris and Charles Mooney that the creation of security interests should not be any more suspect than other transfers of property interests. *See* Harris & Mooney, *supra* note 2, at 2041. Harris and Mooney say that sales of assets, "like secured loans, can result in wealth transfers from the unsecured creditors of a . . . seller and can expose the unsecured creditors to additional risk. . . ." *Id.*

390. *See* Coastal Petroleum v. Chiles, 701 So.2d 619, 623 (Fla. 1st DCA 1997); Wedel v. American Elec. Power Serv. Corp., 681 N.E.2d 1122, 1133 (Ind. Ct. App. 1997); Fritschen v. Wanek, 924 P.2d 1288, 1291 (Kan. Ct. App. 1996); Elenbaas v. Department of Treasury, 585 N.W.2d 305, 307 (Mich. Ct. App. 1998); Will of McConville, 639 N.Y.S.2d 345, 345 (App. Div 1996); HECI Exploration Co. v. Neel, 982 S.W.2d 881, 890 (Tex. 1998).

391. *See supra* Part III.E.

requires the consideration of facts specific to the particular situation. I will distinguish the invalidation proposal from avoidance provisions under current bankruptcy law as well as from statutes that give priority to certain types of liens.

If a prospective invalidation of security interests can create a takings problem, then why are avoidance provisions, which invalidate certain security interests prospectively, constitutional? First, some of the avoidance provisions are based on state law[392] or on provisions in earlier bankruptcy statutes.[393] As a result, they may constitute background principles of property law that define the security interest, unlike recent enactments. In addition, some of the provisions only permit the avoidance of transfers of security interests that give the secured creditor a windfall,[394] and, therefore, the secured creditor would not have reasonable investment-backed expectations. Finally, some of the provisions affect only certain types of collateral,[395] so secured creditors can avoid losing a security interest by not taking a security interest in this type of property at all. For these reasons, the avoidance provisions do not present a takings problem and can be distinguished from a general invalidation of all security interests in bankruptcy.

The invalidation proposal can also be distinguished from statutory grants of priority to particular types of liens, such as ad valorem tax liens, mechanics' liens, and certain environmental liens.[396] These types of statutory grants of priority have been upheld so long as they are applied prospectively. One reason these statutes do not present a takings problem is that the secured creditors receive a benefit related to the prior lien.[397] For example, work done by a contractor resulting in a mechanics' lien or

392. For example, section 544(a), which permits the avoidance of unperfected security interests, and section 548, which permit the avoidance of fraudulent transfers, are based on state law principles. *See* 11 U.S.C. §§ 544(a), 548; *supra* notes 241, 247 and accompanying text.

393. Section 547, which permits the avoidance of preferential transfers, is based on an earlier statute. *See* 11 U.S.C. § 547; *supra* note 262 and accompanying text.

394. Section 548 permits the avoidance of fraudulent transfers and section 547 permits the avoidance of preferential transfers. *See* 11 U.S.C. §§ 547, 548; *supra* notes 245, 260 and accompanying text.

395. Sections 522(f)(1) and 522(f)(2) apply only to exempt property. *See* 11 U.S.C. §§ 522 (f)(1), 522(f)(2); *supra* notes 250, 255 and accompanying text.

396. *See, e.g.*, ARK. CODE ANN. § 8-7-516 (Michie 1987) (environmental superlien).

397. *See* Kessler v. Tarrats, 466 A.2d 581, 596-97 (N.J. Super. Ct. Ch. Div. 1983), *aff'd*, 476 A.2d 326 (1984); Douglas C. Ballantine, Note, *Recovering Costs for Cleaning Up Hazardous Waste Sites: An Examination of State Superlien Statutes*, 63 IND. L.J. 571, 587 (1988). This would not be the case if a superlien attached to a property other than the hazardous waste site. *See generally* Ballantine, *supra*, at 584 (discussing one such statute which was revised to apply only to the waste site); David G. Butterworth, Comment, *State Superfund Superliens: Who Do They Lean On?*, 1 VILL. ENVTL. L.J. 163 (1990) (stating that superlien provisions in effect at that time imposed the lien only on the affected property).

environmental cleanup resulting in an environmental superlien increase the value of the property securing the secured creditor's claim. Therefore, these grants of priority are no different for the secured creditor whose priority has been displaced than for the property owner on whose property a lien has been placed. Another reason that the statutes have been upheld is that the secured creditor has notice of the statutory scheme prior to the attachment of a security interest.[398] Because the types of liens to which this statutory priority are given are limited in type, the secured creditor has some ability to plan and avoid the attachment of liens altogether.[399] Secured creditors take steps to avoid the attachment of mechanics' liens, and they may monitor a borrower's operations to confirm compliance with environmental laws. This ability to use information about the priority scheme to avoid the attachment of a prior lien would preclude a secured creditor from having expectations about priority that are "investment-backed."

Scholars have proposed that involuntary creditors such as tort claimants be given priority over secured creditors as well as over other unsecured creditors.[400] These proposals, applied prospectively, would probably not raise constitutional issues for the same reasons that other priority statutes do not. Secured creditors could simply require that borrowers obtain sufficient liability insurance and could monitor the payment of insurance premiums.[401] Secured creditors would not similarly be able to avoid a general invalidation provision except by avoiding secured credit altogether.

Ultimately, the assumption that Congress may invalidate security interests in bankruptcy altogether by acting prospectively is doubtful. Although the extent of the secured creditors reasonable investment-backed expectations may be small, the character of the governmental action, an appropriation or destruction of a property interest, is, as in *Irving*, extraordinary.[402] The economic impact may also be quite significant. Furthermore, from the point of view of owners of property at the time the legislation was passed, a significant right, the ability to convey a security interest that can withstand bankruptcy, is destroyed. Therefore, it is doubtful that the invalidation proposal would survive a takings challenge.

398. *See* Ballantine, *supra* note 397, at 592.

399. Secured creditors routinely monitor a borrower's payment of taxes, environmental practices, and construction in order to avoid having prior liens attached.

400. *See supra* notes 57-59 and accompanying text.

401. Secured parties currently require casualty insurance and monitor the payment of premiums there. Insurance policies include a mortgagee clause which provides that the policy cannot be canceled without notice to the mortgagee.

402. *Eastern Enterprises* represents the opposite case. There, the investment-backed expectations were significant, and the character of the governmental regulation, the imposition of liability, was a much less significant factor. *See* Eastern Enters. v. Apfel, 118 S. Ct. 2131, 2133 (1998).

More recently, scholars have made more modest proposals regarding the treatment of secured creditors in bankruptcy. I will now turn to a discussion of one of these proposals.

C. *The Partial Priority Proposal*

Professors Bebchuk and Fried recently published an article that has increased the intensity of the debate over the priority of secured creditors in bankruptcy. In their article, Professors Bebchuk and Fried proposed that secured creditors receive only 75% of the amount of their secured claims, treating the remainder of the claims as unsecured and reserving the remaining collateral value for payment of unsecured claims.[403] Professors Bebchuk and Fried did not discuss the takings issue in their first article and discussed it only briefly in their second.[404] In their second article, they did consider the takings issue from the point of view of the property owner as well as the secured creditor.[405] They dismissed the secured creditor's argument on the basis of notice and the owner's argument on the basis that limitations on the right to transfer a security interest do not violate an owner's property rights since there are currently some limitations thereon.[406] They cited no takings cases or scholarship.

With respect to the property owner's point of view, the conclusion reached by Professors Bebchuk and Fried could be correct.[407] Under a partial priority rule, property owners would still have the right to transfer a security interest in their property. The partial priority proposal would be less likely than the invalidation proposal to affect the availability of secured credit and thus less likely to have a negative impact on the transferrablity of an owner's property.

With respect to the secured creditor's point of view, the partial priority proposal can be distinguished from the invalidation proposal. One distinction is the additional dimension to the "denominator problem."[408] With the partial priority proposal, the secured creditor would lose only 25% of the security interest rather than the entire security interest. The Supreme Court has addressed cases in which less than the entire interest of a property owner is taken. In *Pennsylvania Coal Co. v. Mahon*, the Supreme Court found a taking where a statute made the mining of certain

403. *See* Bebchuk & Fried, *The Uneasy Case*, *supra* note 2, at 909.

404. *See* Bebchuk and Fried, *Further Thoughts*, *supra* note 2, at 1290-91.

405. *See id.*

406. *See id.*

407. Their reasoning is, however, incorrect. The constitutionality of some limitations on the rights of property owners to transfer a security interest does not mean that other limitations are constitutional. *See supra* part III.E.

408. *See supra* notes 351-54 and accompanying text.

coal impracticable.[409] In *Keystone Bituminous Coal Ass'n v. DeBenedictis*,[410] the Court found that a similar statute was not a taking. Justice Stevens said "There is no basis for treating the less than 2% of petitioners' coal as a separate parcel of property."[411] However, these cases involved regulation rather than appropriation of property.

The takings formula could be applied to the partial priority proposal as follows. First, the economic impact of the invalidation proposal upon the holder of a security interest could be substantial. The secured creditor would lose 25% of its secured claim except to the extent of assets available to pay unsecured creditors. Second, the character of the government regulation is the same as with the invalidation proposal. The action would be a destruction of a part of the secured creditor's property interest. Finally, as with the invalidation proposal, reasonable investment-backed expectations are arguably not very high since the secured creditor would have actual or constructive notice of the loss of 25% of the security interest in the event of a bankruptcy.

In analyzing the extent of the secured creditor's investment-backed expectations, it is useful to distinguish the partial priority proposal made by Professors Bebchuk and Fried from Professor Warren's proposal which applies both in and out of bankruptcy and is of slightly different effect. Professor Warren proposed a prohibition on secured creditors encumbering all of a debtor's assets in the first place.[412] So what is the difference between the Warren approach, limiting the extent to which an owner can encumber property, and the Bebchuk/Fried approach, limiting the priority of a secured creditor in bankruptcy? Bebchuk and Fried argued that a strength of their approach is the inability of secured creditors to work around the restriction.[413] Their approach requires a secured creditor to share in the loss in bankruptcy regardless of how careful or conservative the secured creditor may have been in making its investment. The Warren approach, on the other hand, would restrict secured lending to some extent, since debtors could not encumber all of their assets, but secured creditors would still be entitled to the most important aspect of their property rights in bankruptcy. Furthermore, by maintaining a low loan-to-value ratio, secured creditors could avoid a loss altogether. With the partial priority proposal, secured creditors could not use prior notice of the partial priority provision to avoid a loss.

As with the invalidation proposal, the most troubling aspects of the partial priority proposal are that it encompasses all security interests, it

409. 260 U.S. 393, 412-15 (1922).
410. 480 U.S. 470, 504-06 (1987).
411. *Id.* at 498.
412. Warren Memorandum to the ALI, *supra* note 5, at 1-2.
413. Bebchuk & Fried, *Further Thoughts*, *supra* note 2, at 1347-48.

invalidates them (at least partially) as to all unsecured claims, and it cannot be avoided by prudent investing on the part of the secured creditor. If the partial priority proposal is considered to be a regulation that reduces the value of a security interest by 25% or less, a finding of a taking is unlikely. On the other hand, if the proposal is seen as a destruction or appropriation of 25% of the secured creditor's interest, the finding of an unconstitutional taking is more likely.

Because of the significant denominator problem raised by the partial priority rule and remaining uncertainty in takings law over the denominator issue, I cannot conclude that it would constitute a taking. However, the proposal does raise significant and complex issues relating to the takings determination. Because of the fact-intensive nature of the takings determination, it is impossible to predict the outcome, and the outcome cannot be assumed.

V. CONCLUSION

Current bankruptcy law for the most part protects property rights, including the rights of secured creditors. Secured creditors do experience delay in bankruptcy in their ability to realize upon their security. However, only the most egregious case of delay could present a successful takings claim. Security interests are subject to avoidance in bankruptcy, but only in limited circumstances that for various reasons do not present a takings problem.

Scholars have suggested that prospective legislation that invalidates security interests in bankruptcy would not create a takings problem. However, the constitutionality of this invalidation proposal is doubtful. All property owners would be affected by legislation that invalidated security interests in bankruptcy because they would not be able to create a security interest that could survive a bankruptcy filing. The right to convey a security interest may be a sufficiently important strand in the bundle of property rights that its abrogation would constitute an impermissible taking. If, because of limitations on the availability of secured credit, the invalidation proposal substantially interfered with the right of an owner to transfer land, it would most certainly be an unconstitutional taking.

In addition, the invalidation proposal may be unconstitutional from the point of view of the secured creditor. Because the proposal would appropriate the secured creditor's property rights rather than regulate them, a court could find the proposal unconstitutional without reaching the ad hoc test of *Penn Central*. Even if the ad hoc test is applicable, a court could find a taking. The extent of the secured creditor's reasonable investment-backed expectations would be limited, but prior notice should not eliminate investment-backed expectations altogether where the secured creditor is not taking the security interest in order to create a takings claim and has no ability to avoid the possibility of loss. Furthermore, the economic impact of the proposal could be substantial, and the character of the regulation, destruction of the secured creditor's property rights, would be extraordinary. As a result, the constitutionality of the invalidation proposal is doubtful.

Although other proposals are not as onerous in affecting the property rights of owners and secured parties, they do still raise substantial constitutional questions. The takings formula is too fact dependent and takings law is still in too much of a muddle to make certain predictions about its application. Scholars making these proposals are ignoring significant and complex takings issues that may make their proposals unconstitutional.

Since Professor Rogers' 1983 article, courts and scholars have made assumptions about the bankruptcy takings problem, most of which are based on his conclusions. However, their assumptions are not correct. The Takings Clause does limit the power of Congress to pass new bankruptcy legislation, even legislation that is prospective. Security interests are interests in property, and new bankruptcy legislation cannot redefine the property interest of a secured creditor. Changes in the treatment of secured creditors in bankruptcy do affect property owners as well as secured creditors, and their rights must be considered in assessing the constitutionality of new bankruptcy legislation. Finally, because the takings formula, in the absence of a categorical taking, requires the application of a fact intensive ad hoc test, the constitutionality of current limitations on the rights of secured creditors does not mean that different limitations would also pass constitutional muster. When the correct assumptions are made, the bankruptcy takings problem becomes much more complex and cannot be dismissed with a short paragraph on prospectivity or the existence of current bankruptcy limitations on secured creditors. The bankruptcy takings problem is still very much alive and must not be ignored.