PROTECTING RIGHTS, PREVENTING WINDFALLS: A MODEL FOR HARMONIZING STATE AND FEDERAL LAWS ON FLOATING LIENS*

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This Article examines the conflict between state law which permits the creation of security interests in a debtor's after-acquired property—or "floating liens"—and federal bankruptcy law's potential cutoff of many of those security interests. This conflict arises in virtually every bankruptcy case. However, because of ambiguous statutory language and a failure of the jurisprudence to balance competing policies, the case law is ad hoc and lacks a conceptual center. This Article argues that using a model of a debtor in liquidation to analyze the cutoff of floating liens would balance the underlying policy considerations and make judicial outcomes more predictable.

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INTRODUCTION

Financiers that lend money on a secured basis often require the borrower, or debtor, to secure the loan not only by existing collateral but also by a security interest in the debtor's future assets.[1] State commercial law governing secured transactions has long recognized and enforced these so-called "floating liens."[2]

1. *See* DAVID G. EPSTEIN ET AL., BANKRUPTCY § 6-68, at 407 (1993). "Especially in business bankruptcies, the typical debtor's property is encumbered by U.C.C. Article 9 security interests that float over the debtor's estate and attach automatically to property of the kinds described in the parties' security agreement whenever the debtor acquires such property." *Id.*

2. *See* U.C.C. § 9-204 cmt. 2 (1995). This Article uses the term "floating lien" in a broad sense to cover any security interest in post-petition collateral. That interest could

If, however, the debtor subsequently becomes the subject of a federal bankruptcy case,[3] bankruptcy law may cut off the floating lien.[4] The cutoff is intended to free up otherwise encumbered assets that the debtor now can use in its reorganization. Unfortunately, case law interpretations of the interplay between the state law floating lien and the bankruptcy cutoff are conflicting, creating troubling inefficiencies in the credit economy. Major commercial and financial transactions are often stymied because even sophisticated parties cannot always know their rights.[5]

The confusion in the case law stems from ambiguous statutory language as well as from a fundamental failure of the jurisprudence in this area to resolve an underlying conceptual dilemma: how to balance the rights of secured creditors with the policy of rehabilitating a debtor in bankruptcy. Bankruptcy law cuts off a floating lien on a debtor's post-petition assets *except* to the extent the lien covers "proceeds, product, offspring, or profits" of pre-petition collateral.[6]

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arise either pursuant to a floating lien under U.C.C. § 9-204 or, for example, where the post-petition collateral constitutes proceeds of pre-petition collateral under U.C.C. § 9-306(2). Because this Article addresses the tension between post-petition collateral and bankruptcy policies, the technicalities by which the post-petition collateral is created are irrelevant.

3. *See* 11 U.S.C. §§ 101-1330 (1994) (the "Code").

4. *See id.* § 552 (post-petition effect of security interest provision). The bankruptcy cutoff does not raise constitutional issues. *See* David Gray Carlson, *Post-petition Interest Under the Bankruptcy Code*, 43 U. MIAMI L. REV. 577, 585 (1989) ("There is little doubt that Congress can adversely affect security interests prospectively, even to the point of banning them altogether. When Congress acts prospectively, bankruptcy legislation helps to constitute the very property interest that a secured party might later claim Congress has taken away."); James S. 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, 987 (1983) ("What, one may ask [can be] 'taken' from the secured creditor? At the time he entered into the security arrangement, he knew or should have known that his rights were circumscribed by the federal legislation.").

5. The author has seen numerous business transactions fail because of uncertainty over the enforceability of a floating lien on franchise fees, utility surcharges, intellectual property licenses, management contracts and other future-arising financial assets that companies increasingly are turning to as a basis for obtaining capital market financing. *See infra* text accompanying notes 23-28. Forming expectations is impossible when the law governing a transaction is unclear. Yet a lender's expectations "are central to the calculation of interest rates and other types of loans, and fulfilling those expectations is therefore important to the efficiency of credit markets." Union Sav. Bank v. Augie Restivo Baking Co. (*In re* Augie/Restivo Baking Co.), 860 F.2d 515, 519 (2d Cir. 1988).

6. Section 552(a) of the Code states that "property acquired by the estate or by the debtor after the commencement of the case is not subject to any lien resulting from any security agreement entered into by the debtor before the commencement of the case." 11 U.S.C. § 552(a). However, subsection (b) provides an exception to this rule:

> (b)(1) Except as provided in sections 363, 506(c), 522, 544, 545, 547, and 548 of this title, if the debtor and an entity entered into a security agreement before the

However, there is no agreement on what these terms mean. For example, if a floating lien covers all of a debtor's existing and future assets, would it extend to the debtor's future assets in bankruptcy because those assets all derive from and therefore are proceeds, product, offspring, or profits of the debtor's pre-petition estate? But if it did extend to all such future assets, would the bankruptcy cutoff be meaningful? Also, is milk the "product" of a cow? The cases are split evenly,[7] causing one judge to observe that "learned folk ... throw up their hands in 'udder' frustration ... ."[8] The confusion increases because bankruptcy law allows a court, "based on the equities of the case,"[9] to cut off a floating lien even on proceeds, product, offspring, or profits of pre-petition collateral.

This issue of how to balance state law floating liens with federal bankruptcy law's cutoff of post-petition security arises in every bankruptcy of a company that has granted such a security interest. Courts have given some thought to the balance, but the resulting jurisprudence is still, at best, ad hoc.[10] To illustrate the problem, consider the

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> commencement of the case and if the security interest created by such security agreement extends to property of the debtor acquired before the commencement of the case and to proceeds, product, offspring, or profits of such property, then such security interest extends to such proceeds, product, offspring, or profits acquired by the estate after the commencement of the case to the extent provided by such security agreement and by applicable nonbankruptcy law, except to any extent that the court, after notice and a hearing and based on the equities of the case, orders otherwise.
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> (2) Except as provided in sections 363, 506(c), 522, 544, 545, 547, and 548 of this title, and notwithstanding section 546(b) of this title, if the debtor and an entity entered into a security agreement before the commencement of the case and if the security interest created by such security agreement extends to property of the debtor acquired before the commencement of the case and to amounts paid as rents of such property or the fees, charges, accounts, or other payments for the use or occupancy of rooms and other public facilities in hotels, motels, or other lodging properties, then such security interest extends to such rents and such fees, charges, accounts, or other payments acquired by the estate after the commencement of the case to the extent provided in such security agreement, except to any extent that the court, after notice and a hearing and based on the equities of the case, orders otherwise.

Id. § 552(b).

7. *See In re* Delbridge, 61 B.R. 484, 486 (Bankr. E.D. Mich. 1986) (discussing why "half the courts dealing with this logically preposterous proposition have adopted [the view that milk is not the product of a cow]"), *aff'd on other grounds*, 104 B.R. 824 (E.D. Mich. 1989).

8. *Id.*

9. 11 U.S.C. § 552(b); *see also infra* notes 249-85 and accompanying text (discussing the equities exception).

10. The jurisprudence is so confusing that Congress, at the behest of hotel industry financiers, attempted to clarify § 552 by amending it and adding subsection (b)(2). *See* Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, § 214, 108 Stat. 4106, 4126. How-

plight of BioTech, a hypothetical pharmaceutical manufacturer, and its creditors.[11] BioTech borrows money from Spendthrift Bank & Trust to begin developing a drug that would block the spread of malignant cancer cells. In return, Spendthrift negotiates for and is granted a security interest in BioTech's then existing *and future arising* inventory. The project becomes more expensive than expected, so BioTech subsequently borrows additional funds from Mover, Shaker & Associates and gives as collateral a security interest in some publicly traded shares of stock that BioTech owns, as well as in its right to receive *payments* under a contract to supply Gargantuan Research Institute with patented cell lines.[12]

A year later, with project costs mounting and the drug no closer to realization, BioTech finds it can no longer afford to pay its creditors on a timely basis. After efforts to renegotiate its debts fail, BioTech files a voluntary petition under Chapter 11 of the Code so that it can delay payment to its creditors and attempt to reorganize.[13]

After the filing, BioTech seeks permission from the bankruptcy court to use the cash proceeds of the sale of pre-petition inventory to purchase new inventory and therefore continue in business.[14] Spendthrift counters that its security interest not only covers such proceeds

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ever, this amendment specifically addresses the application of § 552 to hotel revenues and will not provide a coherent policy for interpreting the provision as a whole. *See infra* notes 224-29 and accompanying text (discussing § 552(b) exception for security interests in hotel revenues).

11. The Biotech hypothetical was inspired by case law precedents. *See, e.g.*, *In re* Lawrence, 41 B.R. 36, 38 (Bankr. D. Minn.) (holding that post-petition milk production is beyond the reach of a floating lien on farm products), *aff'd*, 56 B.R. 727 (D. Minn. 1984).

12. Contract rights may be risky assets to take as collateral. Under § 365 of the Code, a trustee may reject executory contracts that are not advantageous to the bankruptcy estate. *See* 11 U.S.C. § 365 (executory contract provision); *see also* DOUGLAS G. BAIRD, THE ELEMENTS OF BANKRUPTCY 114-41 (rev. ed. 1993) (discussing the operation of § 365). In this hypothetical, we assume a supply contract that is advantageous to BioTech.

13. When a company files a bankruptcy petition, a creditor's right to foreclose on collateral or collect debts is automatically suspended. *See* 11 U.S.C. § 362(a) (automatic stay provisions).

14. BioTech's argument would be based on 11 U.S.C. § 552(b), stating that a court, "based on the equities of the case," may terminate a floating lien on proceeds of pre-petition collateral. *See infra* notes 249-85 and accompanying text; *see also In re* Lawrence, 41 B.R. at 38 ("Even if the Court had determined that the post-petition milk was subject to the Bank's security interest under § 552(b), the Court would reach the same end result. Section 552(b)'s exception has a proviso giving the Court power to terminate a security interest despite the protection otherwise provided by 552(b) based on balancing the equities of the case."). BioTech also could have moved under 11 U.S.C. § 363(e) to use the cash proceeds to purchase new inventory so long as Spendthrift received "adequate protection," such as a lien on the new inventory. See *infra* notes 100-35 and accompanying text for a discussion of adequate protection.

but also extends to all newly arising inventory purchased with such proceeds.[15] BioTech also seeks the court's permission to finance its reorganization with the dividends payable on the stock[16] and with the payments to become due under its supply contract with Gargantuan.[17] But Mover maintains that those payments are subject to its security interest.[18]

In considering these motions, the bankruptcy court struggled with the competing policies of rehabilitating debtors and preserving creditors' expectations. BioTech argued that the court should invoke the fresh start principle[19] underlying the Code and give it the proceeds and payments to facilitate its reorganization.[20] On the other hand, Spendthrift and Mover argued that they advanced money to BioTech because they expected the courts to enforce their contractual rights to be repaid from the bargained-for collateral.

Faced with an ambiguous statute and the absence of clear case law guidance, and in order to promote BioTech's reorganization, the bankruptcy court invalidated Mover's security interest in both the dividends and the future contractual payments;[21] it also invalidated Spendthrift's security interest in the portion of the inventory's sale

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15. Spendthrift's argument would be based on U.C.C. § 9-306(1) and *In re* Bumper Sales, Inc., 907 F.2d 1430 (4th Cir. 1990), discussed *infra* in notes 182-92 and accompanying text.

16. See *infra* notes 160-79 and accompanying text for a discussion of floating liens on stock dividends.

17. See *infra* notes 198-219 and accompanying text for a discussion of floating liens on contracts.

18. And therefore that BioTech, as debtor-in-possession, must obtain the court's permission and provide adequate protection in order to use such payments because they constitute cash collateral. *See* 11 U.S.C. § 363(c)(2), (e).

19. The fresh start principle is that honest, but unfortunate, debtors should have the opportunity to reorganize and begin anew. This policy "underl[ies] the entire Bankruptcy Code." *In re* Lawrence, 41 B.R. at 37. For a more detailed discussion of the fresh start concept, see *infra* notes 93-151 and accompanying text.

20. BioTech then would not have to provide adequate protection with respect to post-petition inventory. *See supra* note 14.

21. F.D.I.C. v. Hastie (*In re* Hastie), 2 F.3d 1042 (10th Cir. 1993), discussed *infra* in notes 160-72 and accompanying text, has been interpreted by some to allow the cutoff of a lien on stock dividends. A dictum in *United Virginia Bank v. Slab Fork Coal Co.*, 784 F.2d 1188 (4th Cir. 1986), leaves open the possibility that the Code allows courts to refuse to recognize an otherwise valid security interest in post-petition proceeds of pre-petition collateral on the grounds that invalidating the security interest would promote the debtor's fresh start. *See id.* at 1191; *accord In re* Vanas, 50 B.R. 988, 997 (Bankr. E.D. Mich. 1985); *In re* Serbus, 48 B.R. 5, 8 (Bankr. D. Minn. 1984); *In re* Lawrence, 41 B.R. at 38. *But see* J. Catton Farms, Inc. v. First Nat'l Bank of Chicago, 779 F.2d 1242, 1246-47 (7th Cir. 1985); Wolters Village, Ltd. v. Village Properties, Ltd. (*In re* Village Properties, Ltd.), 723 F.2d 441, 444 (5th Cir. 1984); *infra* notes 249-85 and accompanying text.

proceeds that represents BioTech's profit. Spendthrift and Mover are outraged. They both plan to demand higher interest rates from the next risky company, like BioTech, that seeks financing from them.[22] Perhaps they will withhold financing altogether.

The problem becomes even more critical from the standpoint of parties trying to *plan* commercial and financial transactions that rely on future cash flows from financial assets.[23] An entire industry that, according to the Securities and Exchange Commission, is "becoming one of the dominant means of capital formation in the United States"[24]—asset securitization—depends on these cash flows.[25] A company originating financial assets sells them to a newly created special purpose vehicle ("SPV") that, in turn, funds the purchase of the financial assets by issuing securities in the capital markets.[26] Those securities must be rated at an acceptable level by independent rating agencies or else investors will not buy them.[27] The rating agencies, however, use a methodology that assumes the worst case—a bankruptcy of the company and repayment coming solely from the financial assets—in assessing the riskiness of the rating given to the SPV's securities. Accordingly, the ambiguity of § 552 can raise profound concerns in asset securitization deals that depend, as they increasingly do, on future-arising financial assets.[28]

This ambiguity reflects a failure of the law to distinguish two fundamental, and fundamentally different, ways in which post-

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22. That does not mean that the company will agree to pay a higher interest rate. Other lenders, not yet so outraged, may be prepared to lend at the original rate until the loan market adjusts to the risk. Of course, interest rates do not necessarily go up every time a secured lender suffers a loss in a bankruptcy case. A lender might conclude that the chance of the debtor going bankrupt is so remote and the potential impact of § 552 so ambiguous as to justify ignoring the issue. The more likely impact, therefore, is on business transactions that depend on after-acquired property for repayment. *See supra* note 5 and *infra* text accompanying notes 23-28.

23. Financial assets are assets that represent rights to payments at future dates, such as intellectual property licenses and management contracts. *See supra* note 5.

24. Investment Company Act Release No. 19105, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,062, at 83,500 (Nov. 19, 1992) (provided in connection with the issuance of Rule 3a-7 under the Investment Company Act of 1940).

25. *See* Steven L. Schwarcz, *The Alchemy of Asset Securitization,* 1 STAN. J. L. BUS. & FIN. 133, 135 (1994) [hereinafter Schwarcz, *Alchemy*].

26. *See id.* at 135-36.

27. *See id.* at 136.

28. See *infra* notes 236-48 and accompanying text for a discussion of the application of § 552 to "true sales" in asset securitization transactions. Many asset securitization deals are structured as secured transactions and not true sales, see Schwarcz, *Alchemy*, *supra* note 25, at 140 n.26, in which case § 552 would be directly applicable to the bankruptcy analysis.

petition collateral can arise. First, an asset subject to a pre-petition security interest can *change form*, such as happened to the inventory which, when sold, changed form to receivables and ultimately to money. This Article will introduce the term "liquidating collateral"[29] to describe this type of asset, and will refer to assets that replace or substitute for liquidating collateral[30] as "replacement collateral." Under both existing law[31] and intuitive reasoning, replacement collateral should be subject to the floating lien.

A fundamentally different way in which post-petition collateral can arise is where after-acquired assets do *not* replace liquidating collateral. If these assets also are subject to a lien under non-bankruptcy law, this Article will refer to such assets as "non-replacement" collateral. An example of non-replacement collateral would be the dividends payable on the publicly traded stock.[32]

It is not at all intuitive that bankruptcy law should allow a floating lien to attach to non-replacement collateral. Under existing law, that issue would be analyzed by asking whether the non-replacement collateral constitutes "proceeds, product, offspring, or profits" of pre-petition collateral; but such a causation test does not effectively address the tension between bankruptcy and commercial law.[33] On the

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29. *See infra* text accompanying note 81.

30. To the extent such assets also are subject to a lien under non-bankruptcy law.

31. *See* 11 U.S.C. § 552(b) (1994).

32. *See infra* notes 160-79 and accompanying text. Another example of non-replacement collateral would be a factory constructed by a debtor operating in Chapter 11, assuming, of course, that the factory is subject to the pre-petition lien and the debtor does not use cash collateral to construct it.

33. Existing bankruptcy law generally cuts off floating liens on post-petition assets, subject to the exceptions listed above. Professor David Gray Carlson suggests a technical analogy to rationalize this cutoff. Suppose A owns inventory (I_1) and conveys a security interest in I_1 to SP. A then sells I_1 to B in a bulk sale. SP's security interest would continue in I_1 because a bulk sale is not a purchase in the ordinary course of business. *See* U.C.C. §§ 1-201(9), 9-306(2), 9-307(1) (1995). B subsequently buys more inventory (I_2). Does SP have an after-acquired property security interest in I_2?

The answer depends on whether the funds used to buy I_2 were proceeds of I_1. If they were, then SP's security interest would continue in I_2. *See* U.C.C. § 9-306(2). If they were not, then SP's security interest would not continue in I_2 because I_2 does not derive from I_1 and B never signed a security agreement with SP. SP's after-acquired property rights arise from the contract between A and SP. Unless B expressly promises to assume this security agreement, I_2 is unencumbered. *See* David Gray Carlson, *Bulk Sales Under Article 9: Some Easy Cases Made Difficult*, 41 ALA. L. REV. 729, 763-91 (1990).

This case can be analogized to bankruptcy. The pre-petition debtor is A—admittedly bound by the security agreement with SP. The bankruptcy trustee is B. The trustee is not bound on the security agreement because the trustee is not the same entity as A. This is equally true in Chapter 11 where the trustee is also the debtor-in-possession. The debtor-in-possession has a separate capacity when serving as bankruptcy trustee, and therefore is

one hand, the more assets a pre-petition lien is allowed to encumber, the less likely it will be that the debtor can successfully reorganize in bankruptcy. Floating liens should not, for example, be permitted to deprive a debtor of its profit incentive to operate a business in Chapter 11. On the other hand, a secured creditor should be entitled to the benefit of its contractual bargain where debtor rehabilitation is not impeded. Permitting a floating lien always to attach to non-replacement collateral would discourage rehabilitation. But always cutting off a floating lien in non-replacement collateral would deprive a secured creditor of its contractual bargain even where the lien would not impede the debtor's ability to reorganize. The answer therefore lies in the balance.

To reach that balance, this Article proposes a model that distinguishes the treatment of replacement and non-replacement collateral in a way that harmonizes a debtor's right to a fresh start with a secured creditor's contractual bargain: *Creditors that are secured by after-acquired property should receive in bankruptcy, on account of their floating lien, what they would receive if their lien continued but the debtor were liquidated.* This result would obtain irrespective of whether the debtor actually liquidates or reorganizes. It effectively limits the security interest in after-acquired collateral to assets that would become part of the debtor's estate in a liquidation.

Part I of this Article describes the current treatment of replacement and non-replacement collateral under state and federal law, and explains how the proposed liquidation model is designed to strike a balance between them.[34] Part II evaluates the liquidation model,

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not bound (except to the extent of liens that have vested pre-petition) on the pre-petition security agreement. Accordingly, SP's security interest would only continue in post-petition collateral that derived from pre-petition collateral.

This analogy may not, however, provide a complete explanation of the cutoff of floating liens. While it fixes a balance between secured creditor claims and the debtor's right to a fresh start in bankruptcy, it does not fully explore the consequences of that balance. Of course, one may argue that secured creditors should expect exactly what the law tells them they can expect. This Article, however, argues that in rethinking the law an approach based on balancing the competing commercial law and bankruptcy *policies* will yield the most meaningful result.

34. *See infra* notes 48-92 and accompanying text. Some may ask whether there is a less intrusive way than the liquidation model to harmonize state commercial law with federal bankruptcy law. One approach, for example, might be to simply clarify the definition of "proceeds, product, offspring, or profits" under 11 U.S.C. § 552(a). However, as shown in Part III.B.5 (describing that a recent "clarification" of § 552's application to hotel revenues has left possible ambiguities and inconsistencies), one cannot even attempt to clarify these terms without resolving the more fundamental question of what post-petition collateral *should* be subject to pre-petition lien. The liquidation model is an attempt to resolve that underlying question.

showing that it is fair both to creditors and debtors and is consistent with commercial law and bankruptcy policies.[35] Part III illustrates how the liquidation model would be applied, and also compares the model with existing bankruptcy law approaches and demonstrates that it would further systematize the jurisprudence.[36] Annex A to this Article proposes statutory language to help implement the liquidation model.[37] Annex B illustrates differences in outcomes under existing law and under the liquidation model.[38] Finally, Annex C refers the reader to portions of the Article that explain significant concepts.[39]

Several points must be clarified at the outset. First, the liquidation model only addresses whether property acquired by the debtor *after* the date of the bankruptcy will be subject to a floating lien. Bankruptcy policy does not purport to affect a security interest in property existing prior to that date. A secured party therefore would be entitled, as under current law, to any appreciation in the market value of the pre-petition collateral, and cannot under the liquidation model be "cashed out" by a low valuation.[40] The model thus recognizes a distinction between the appreciating value of existing collateral in which a lien has already attached under state law *prior* to bankruptcy, and the separate issue (on which the model focuses) of whether bankruptcy should respect a secured party's lien that attaches to assets first created *after* the debtor's bankruptcy.

Collateral also can depreciate.[41] To understand the relation between depreciation and the liquidation model, one must keep a number of concepts separate. First, the liquidation model should not

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35. *See infra* notes 93-152 and accompanying text.

36. *See infra* notes 153-285 and accompanying text.

37. *See infra* Annex A.

38. *See infra* Annex B.

39. *See infra* Annex C.

40. *See, e.g.*, Dewsnup v. Timm, 502 U.S. 410, 417 (1992) (holding that a lien on real property continues in bankruptcy so that "[a]ny increase over the judicially determined valuation during bankruptcy rightly accrues to the benefit of the creditor, not to the benefit of the debtor"); *cf.* 11 U.S.C. § 1111(b) (1994) (giving the secured creditor the option, in a reorganization under Chapter 11 of the Code, not to be "cashed out" for the appraised value of the collateral, and therefore to realize its eventual market value); *id.* § 1129(b) (stating that a bankruptcy court may not "cram down" a plan of reorganization over the dissent of an objecting class of secured creditors unless the plan pays at least the value of the collateral).

41. By depreciation, we mean the "wearing out of plant and capital goods, such as machines and equipment." JOHN DOWNES & JORDAN ELLIOT GOODMAN, DICTIONARY OF FINANCE AND INVESTMENT TERMS 135 (4th ed. 1995).

be confused with a secured creditor's right to adequate protection[42] for depreciating collateral. That right already exists under law.[43] In contrast, the liquidation model is not intended to create rights; rather, it helps to determine how bankruptcy should *limit* a security interest created under non-bankruptcy law.[44]

Second, the application of the "replace or substitute" standard of the liquidation model to depreciating collateral might be confusing because depreciation sometimes clearly results in replacement collateral, but often does not. The model would run into intractable problems of measuring causation unless it sets a threshold standard for determining when depreciating assets are deemed to be replaced by other assets. This Article therefore will treat collateral that reduces in value solely by reason of depreciation as non-liquidating collateral *unless* the collateral generates assets whose value plainly correlates to the reduction in value. Milk of a cow or widgets produced by a machine are examples of assets whose value does not plainly correlate to the reduction in value of the underlying collateral. A cow and a machine each declines in value by reason of depreciation because both have finite useful lives. Yet each should be treated under the model as non-liquidating collateral because the milk produced by a cow and the widgets produced by a machine during a given period do not plainly correlate to the reduction in value of the cow or the machine during that period—indeed, the cow or the machine may be worth more or less at the end of the period depending on the then applicable market value of cows or used machines, irrespective of the milk or widgets actually produced during such period.

Treating depreciating collateral under the model as non-liquidating does not prejudice the secured party because secured creditors already have a right under existing law to adequate protection for depreciating collateral.[45] For example, say a secured creditor

42. For an explanation of adequate protection, see *infra* note 112 and accompanying text.

43. A secured creditor is entitled to "adequate protection" under 11 U.S.C. § 361 for depreciating collateral during the period of the bankruptcy stay's prevention of the creditor's foreclosing on the collateral.

44. *See infra* discussion in text accompanying notes 47-58.

45. We recognize this solution is a practical compromise and not entirely consistent, for example, with this Article's treatment of a lease as replacement collateral for the underlying leased property. *See infra* text accompanying notes 194-97. One could have argued that the secured creditor should be limited to adequate protection for the debtor's leasing of collateral. *See* 11 U.S.C. § 363 (1994). Nonetheless, a distinction can be made between depreciation and leasing. Depreciation is widespread and not entirely within the

has a pre-petition lien on a machine used by a debtor to produce widgets and on the widgets themselves. If the machine depreciates in the debtor's bankruptcy, the secured creditor would be entitled to adequate protection under existing law. Thus, there would be no need to determine under the liquidation model whether the widgets constitute replacement collateral for the machine.

The model also does not—nor does it need to—address the right of the holder of a floating lien to be protected on a present value basis through post-petition interest.[46] The job of the model is rather to determine which portions of a bankrupt debtor's after-acquired property should be subject to a floating lien. Once that determination is made, other rules of bankruptcy that have nothing to do with floating liens and that are based on independent policy considerations will govern whether or not post-petition interest accrues.[47]

Furthermore, the liquidation model does not purport to empower a secured creditor with any rights that it does not already have under non-bankruptcy law. The model instead provides guidance as to how bankruptcy law should limit those non-bankruptcy rights. *The discussion throughout this Article therefore assumes that the applicable security interest already covers the relevant after-acquired property under non-bankruptcy law.*

Finally, the model is not intended to—and indeed it is doubtful that any model could—create formulaic certainty. Rather, the goal of the model is to reduce ambiguity by providing a more intuitive and perhaps rational way of thinking about the balance between creditor expectations and debtor rehabilitation.

I. PROPOSED LIQUIDATION MODEL

After explaining the concept of security interests and describing their treatment in bankruptcy, this Part examines how bankruptcy courts should recognize security interests in after-acquired property.

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debtor's control. Also, the relationship between a depreciating asset and replacement assets is tenuous at best. To apply the liquidation model to depreciation therefore would be burdensome and costly. That existing law already addresses depreciating collateral makes that application unnecessary. A post-petition lease, on the other hand, is within the debtor's sole control and is not a typical occurrence. Therefore, applying the liquidation model, which more directly protects a secured creditor than does giving adequate protection, should not be burdensome or costly.

46. Post-petition interest is interest accruing during the pendency of the bankruptcy case.

47. *See* 11 U.S.C. § 506(b) (1994) (entitling an oversecured creditor to interest as provided by pre-petition agreement); United Savs. Ass'n v. Timbers of Inwood Forest Assocs., Ltd., 484 U.S. 365 *passim* (1988).

A. *After-Acquired Collateral Provisions of State Law*

Creating a security interest enforceable against third parties is simple and formalistic.[48] Debtors who follow the formal steps outlined in the Uniform Commercial Code ("UCC") demonstrate that they understand and consent to the creditor's taking a security interest in the collateral. Creditors who satisfy these prerequisites can expect that a court will recognize the resulting security interest. Additionally, by following these prerequisites, creditors notify third parties of their interest in the collateral so that the third parties can make financial decisions accordingly.

The creation of a security interest is a two-step process. First, the security interest must attach so that it is enforceable against the debtor.[49] Attachment occurs when (1) either the debtor and creditor sign a written security agreement that contains a description of the collateral[50] or the creditor takes possession of the collateral; (2) the creditor has given value to the debtor; and (3) the debtor has rights in the collateral that it can give to the creditor.[51] Second, the creditor must perfect the security interest in order to make it enforceable against third parties.[52] Perfection is a means of notifying third parties of the creditor's claim to the collateral.[53] The creditor perfects a security interest by filing a financing statement in the appropriate location or, in certain instances, by taking possession of the collateral.

The UCC recognizes two kinds of security interests in after-acquired property. UCC section 9-204 states that "a security

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48. For a general overview of the law governing the creation of a security interest, see BARKLEY CLARK, THE LAW OF SECURED TRANSACTIONS UNDER THE UNIFORM COMMERCIAL CODE ch. 2 (rev. ed. 1994 & Supp. 1995); ALAN SCHWARTZ & ROBERT E. SCOTT, COMMERCIAL TRANSACTIONS: PRINCIPLES AND POLICIES 528-30 (1991); JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE §§ 22-1 to -20 (3d ed. 1988); *see also* U.C.C. § 9-201 (1995) ("General Validity of Security Agreement").

49. *See* U.C.C. § 9-203 (1995). One casebook colorfully explains attachment:

> A security interest is a bundle of rights in property—the collateral—which bundle belongs to the secured party. It will sometimes be useful to know *when* a secured party obtains his security interest, when his bundle of rights hooks onto, or *attaches* to, the collateral.

ROBERT J. NORDSTROM ET AL., PROBLEMS AND MATERIALS ON SECURED TRANSACTIONS 113 (1987).

50. The description needs to identify the collateral, but it does not have to be detailed. *See* U.C.C. § 9-110 (1995); SCHWARTZ & SCOTT, *supra* note 48, at 528.

51. *See* U.C.C. § 9-203.

52. *See id.* §§ 9-302 to -306.

53. "Protection of third parties from 'secret' undisclosed liens is a central purpose of publicizing security interests through perfection. Because the assets available to satisfy other creditors' claims are diminished, a security interest necessarily increases the risk of subsequent loans to the debtor." SCHWARTZ & SCOTT, *supra* note 48, at 529.

agreement may provide that any or all obligations covered by the security agreement are to be secured by after-acquired collateral."[54] This type of after-acquired property clause allows creditors to "[extend] the ... security interest to property acquired after an initial loan as well as to property then owned by the debtor."[55] It is "especially common ... with respect to loans on collateral that 'turns over' such as inventory and accounts."[56] The section 9-204 security interest is "often called a 'floating lien,' for it 'floats' over both existing and after-acquired property of the debtor."[57] The second type of UCC-created security interest in after-acquired property is the security interest in proceeds, which are defined in UCC section 9-306 as "whatever is received upon the sale, exchange, collection or disposition of collateral or proceeds."[58]

Security interests in after-acquired property are recognized as much for pragmatic as for theoretical reasons.[59] Official Comment 2 to UCC section 9-204 explains part of the rationale:

> [Section 9-204] rejects the doctrine—of which the judicial attitude toward after-acquired property interests was one expression—that there is reason to invalidate as a matter of law what has been variously called the floating charge, the free-handed mortgage and the lien on a shifting stock....
>
> The widespread nineteenth-century prejudice against the floating charge was based on a feeling, often inarticulate in the opinions, that a commercial borrower should not be allowed to encumber all his assets present and future, and that for the protection not only of the borrower but of his other creditors a cushion of free assets should be preserved. That inarticulate premise has much to recommend it.... Article [9 of the UCC] decisively rejects it not on the ground that it

54. U.C.C. § 9-204 (1995).

55. WHITE & SUMMERS, *supra* note 48, § 23-6, at 1095; *accord* CLARK, *supra* note 48, § 10-3.

56. WHITE & SUMMERS, *supra* note 48, § 23-6, at 1095.

57. *Id.*

58. U.C.C. § 9-306(1). According to the Permanent Editorial Board for the Uniform Commercial Code: "[P]roceeds are a species of after-acquired property [and] in many cases the same result as that arising under [section] 9-306(2) could be achieved ... by describing the after-acquired property in the security agreement." PERMANENT EDITORIAL BOARD FOR THE UNIFORM COMMERCIAL CODE, PEB STUDY GROUP UNIFORM COMMERCIAL CODE ARTICLE 9 REPORT 106-07 (1992) [hereinafter PEB REPORT]; *see also* CLARK, *supra* note 48, § 10.01[2][a] ("[A]fter-acquired property will frequently qualify as second generation proceeds, ... as when a dealer sells an appliance and reinvests the cash proceeds in new inventory.").

59. The remainder of Part I.A was prepared with the able assistance of Nhan Vu, a 1995 graduate of Yale Law School.

> was wrong in policy but on the ground that it was not effective. In pre-[UCC] law there was a multiplication of security devices designed to avoid the policy: field warehousing, trust receipts, factor's lien acts and so on. The cushion of free assets was not preserved. In almost every state it was possible before the [UCC] for the borrower to give a lien on everything he held or would have.... This Article, in expressly validating the floating charge, merely recognizes an existing state of things.[60]

Pragmatism, however, is not the only reason for recognizing floating liens. If debtors and creditors invented ingenious ways to get around this common-law prejudice, then compelling economic reasons must support the existence of after-acquired property clauses. These clauses, for example, can increase financing opportunities by enabling debtors to borrow greater amounts than their current assets could support.[61]

Floating liens also can help debtors by reducing their transaction costs.[62] Debtors and creditors do not have to sign new security agreements and file new financing statements each time debtors grant a separate and identifiable asset as collateral. This facet of the floating lien is especially useful when a creditor wishes to secure itself with changing assets, such as inventory that is constantly being sold and replaced by similar goods. Without the advantage of a floating lien, the debtor and creditor would have to go through extensive paperwork with each turnover in collateral.

The focus of this Article, however, is not ultimately on the efficiency or desirability of floating liens under state law. The Article *assumes* the continued existence of floating liens under state law[63] and

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60. U.C.C. § 9-204 cmt. 2.

61. By the same token, the flexibility of allowing after-acquired property clauses should not hurt sophisticated debtors because companies that do not need the extra financing will not grant after-acquired security interests. Our laws no longer presuppose that a debtor, particularly one that is sophisticated, needs to be protected from its own business decisions. For a discussion of whether floating liens are fair to unsecured creditors, see *infra* notes 123-35 and accompanying text.

62. This reduction is particularly noteworthy because debtors customarily pay for all of a secured lender's transaction costs as well as for their own.

63. For a discussion of the efficiency of floating liens under state law, see Steven L. Harris & Charles W. Mooney, Jr., *A Property-Based Theory of Security Interests: Taking Debtors' Choices Seriously,* 80 VA. L. REV. 2021, 2063-64 (1994) (arguing that a floating lien is not inconsistent with the law's general refusal to enforce a debtor's contractual promise to prefer particular creditors and that there is nothing unfair about permitting a secured creditor priority when earlier-in-time creditors have not chosen to obtain security themselves and all creditors have an opportunity to discover the existence of the secured creditor).

focuses on how to balance the expectations thereby created with the federal law policy of debtor rehabilitation.

B. *After-Acquired Collateral Under Federal Bankruptcy Law*

Predicting when a bankruptcy court will recognize a security interest that *does not* involve after-acquired property is easy.[64] The bankruptcy trustee,[65] or, absent such appointment, the debtor itself (which is deemed to have the powers of a bankruptcy trustee), generally cannot set aside a security interest that was created and perfected more than ninety days before the debtor filed a bankruptcy petition. However, the trustee may be able to set aside a security interest if the creditor has failed to perfect at the time of the bankruptcy[66] or (in some cases as a preferential transfer) if the creditor perfects less than ninety days before bankruptcy.[67]

Predicting when a bankruptcy court will recognize a security interest that *does* involve after-acquired property, however, is not so easy. The courts have not yet developed an overarching theory for evaluating these security interests.[68] To understand whether a bankruptcy court *should* recognize security interests in after-acquired property, let us consider three hypothetical situations, the first two of which are variations of our earlier case, Biotech.

First, recall the scenario in which Mover, Shaker & Associates took a security interest in BioTech's right to receive $2 million under

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64. For an overview of the rights of secured creditors in bankruptcy, see BAIRD, *supra* note 12, at 83-113, 165-92.

65. For a description of the role of a bankruptcy trustee, see *id.* at 8.

66. *See* 11 U.S.C. § 544(a) (1994).

67. *See id.* § 547. If a creditor perfects a security interest less than ninety days before the debtor files a bankruptcy petition, the trustee may be able to void the security interest as a preferential transfer. A preferential transfer results when there was a transfer of property of the debtor to or for the benefit of a creditor on account of an antecedent debt owed by the debtor before the transfer was made. The transfer must have been made within ninety days before the petition was filed (unless an insider was involved in the transaction) and while the debtor was insolvent. The transfer must not enable the creditor to receive more than he would have received in a Chapter 7 liquidation. *See id.* § 547(b).

Granting a security interest is considered a transfer of property. Under the Code, the transfer is deemed to have been made when the security interest is perfected. *See id.* § 547(e)(2). However, if the creditor perfects a security interest within ten days of its creation, the Code states that a transfer is made at the time when the interest was created. *See id.* Thus, if a creditor perfects a security interest *more* than ten days after the interest was created and within the ninety days before bankruptcy, the court may find that a preferential transfer has occurred.

68. For a discussion of current case law evaluating the recognition of after-acquired property in bankruptcy, see *infra* notes 153-285 and accompanying text.

a supply contract with Gargantuan Research Institute. After BioTech files its bankruptcy petition, Gargantuan sends it a $500,000 check to pay for the first shipment of cell lines.[69] Should the court recognize Mover's security interest in the check? Recognizing Mover's security interest in the check makes sense. Although the check is a newly acquired asset of BioTech, it substitutes for a portion of the contract, whose value has been reduced to $1.5 million. Thus, the $500,000 check maintains Mover's pre-petition collateral position. Forcing Mover to forfeit the $500,000 check to BioTech's reorganization would impair the benefit of its bargain, which in turn would adversely affect the credit economy.[70] If lenders cannot rely on the legal system to protect the benefit of their bargains, they will charge higher interest rates to compensate for their greater risk and may well deny capital to risky, but worthwhile, ventures.

Second, recall the scenario in which Spendthrift Bank & Trust took a security interest in BioTech's existing and future inventory. After BioTech filed a bankruptcy petition, it sold the inventory then in its possession (valued by Biotech at $1 million) for $1.2 million, yielding a $200,000 profit. Because the $1.2 million cash proceeds replaces the pre-petition inventory, Spendthrift would benefit from the collateral appreciation.[71] On the other hand, refusing to recognize the floating lien on proceeds would deny Spendthrift the collateral protection for which it bargained under state law.[72]

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69. This example is "frictionless" in the sense that it assumes BioTech will have no cost of producing and shipping the cell lines. In the real world, however, BioTech will have such cost. See *infra* notes 263-85 and accompanying text for an argument that BioTech, under §§ 552(b) and 506(c) of the Code, may deduct its cost incurred post-petition from the amount of each check. If BioTech had no way of recouping this cost, it would have little incentive in bankruptcy to continue performing the supply contract. By recouping this cost, BioTech is motivated to perform the contract in order to realize any surplus after Mover's debt is paid in full. *See* U.C.C. §§ 9-502(2), 9-504(2) (1995).

70. Courts have consistently recognized the importance of predictability to the credit economy. *See supra* note 5.

71. *See* Dewsnup v. Timm, 502 U.S. 410 *passim* (1992); *accord In re* Ed Woods Livestock, Inc., 172 B.R. 294, 295 (Bankr. D. Neb. 1994) (holding that the secured creditor was entitled to increased post-petition market value of hay). However, under commercial law, a secured creditor cannot receive more than repayment of principal and accrued interest, irrespective of the amount of the collateral. *See* U.C.C. § 9-502(2).

72. Ignoring the Supreme Court's recognition of collateral appreciation and arguing that Spendthrift is only entitled to the *value* of its pre-petition collateral would lead to impractical results. Bankruptcy courts simply cannot conduct valuation hearings for every item of post-petition collateral. See, for example, *FDIC v. Hastie* (*In re* Hastie), 2 F.3d 1042, 1046 (10th Cir. 1993) in which the court stated that: "In our judgment, the Byzantine factual inquiry that would attend a proceeds rule based upon whether the cash dividends did or did not diminish the value of the stockholder's equity in the stock would not be justified in expense or helpfulness. . . ." *Id.* at 1046; *see also infra* notes 160-72 and

Third, consider the situation of Gold Digger Credit Corp., in which recognizing security interests in after-acquired collateral does not make sense. Gold Digger makes a $300,000 loan to Jim's Jewelry Store and secures it with a floating lien on the Store's inventory. The Store uses the loan to buy trendy plastic rings in exotic shades of neon. The trend, alas, passes quickly and the Store, unable to sell the rings, files a petition to reorganize in bankruptcy.

During the reorganization, the Store decides that a more upscale line of merchandise would salvage the business and obtains a $150,000 unsecured line of credit from Southwest Bank. The Store uses the credit to purchase a new inventory of diamond tennis bracelets. It also sells the plastic rings to Five & Dime Ltd. for the nominal amount of $500. Gold Digger's security interest should extend to the $500 check from Five & Dime but not to the new inventory of tennis bracelets. The check from Five & Dime substitutes for inventory in existence on the day of the Store's bankruptcy. However, the new inventory of tennis bracelets does not replace the pre-petition inventory, and would vastly improve Gold Digger's position.[73] Furthermore, if Gold Digger could use its floating lien to claim a security interest in the new inventory, lenders like Southwest would be unwilling to supply capital to reorganizing companies like the Store, and that result would frustrate the rehabilitative purpose of bankruptcy reorganization.[74]

C. A Model for Balancing State and Federal Interests

In order to distinguish assets like the Store's new inventory of tennis bracelets from assets like proceeds of pre-petition collateral and contractual payments, we propose a liquidation model. Debtors have the option of filing either for a Chapter 7 liquidation[75] or a Chapter 11 reorganization. Creditors cannot always prevent a debtor

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accompanying text (discussing *Hastie*). Recognizing Spendthrift's security interest in *all* of the proceeds avoids the need for a valuation hearing. *Cf. infra* notes 145-51 and accompanying text (explaining that the liquidation model is not based on valuation).

73. *See* PETER F. COOGAN ET AL., SECURED TRANSACTIONS UNDER THE UNIFORM COMMERCIAL CODE § 7B.05, at 7B-35 (1963) ("To allow the floating lienor to prevail as to assets which the debtor acquired through the new value provided by the purchase money credits arguably would give a windfall to the floating lienor.").

74. If Gold Digger could use its floating lien to claim a security interest in the tennis bracelets, it would have a situational monopoly. Under the UCC, Southwest Bank could have used a purchase money security interest ("PMSI") to defeat that monopoly. The issue of situational monopolies, and the use of PMSIs to defeat them, is discussed *infra* notes 94-135 and accompanying text.

75. In Chapter 7, the entity liquidates its assets. *See* BAIRD, *supra* note 12, at 5.

from choosing liquidation.[76] In a Chapter 7 liquidation, the bankrupt entity effectively ceases its ongoing business and generates no new assets from operations other than as may result from winding up the business. The bankruptcy trustee is obligated to "collect and reduce to money the property of the estate . . . and close such estate as expeditiously as is compatible with the best interests of parties in interest."[77] To maximize the estate's value, the court also may "authorize the trustee to operate the business of the debtor for a limited period, if such operation is in the best interest of the estate and consistent with the orderly liquidation of the estate."[78] Creditors must satisfy their claims from assets of the liquidating debtor. Therefore, when creditors bargain for collateral, they must seek terms that thoroughly secure them against loss in the event that the borrower opts for a Chapter 7 liquidation,[79] and they are in peril if they fail to obtain such terms.[80] The liquidation model would repay a secured creditor in accordance with that scenario.

During the liquidation, some items of collateral will turn into new assets, typically cash or accounts receivable. These new assets replace or substitute for the original collateral. For ease of reference,

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76. The debtor has the discretion to file a voluntary liquidation under Chapter 7: "A voluntary case under a chapter of this title [11] is commenced by the filing with the bankruptcy court of a petition under such chapter by an entity that may be a debtor under such chapter." 11 U.S.C. § 301 (1994). Section 109(b) of the Code provides that any person other than a railroad, insurance company, or bank may be a debtor under Chapter 7. *See id.* § 109(b). Section 706(b) of the Code provides that, on request of a party in interest (such as a creditor), and after notice and a hearing, the bankruptcy court may decide to convert a Chapter 7 liquidation to a Chapter 11 reorganization; the creditor has no assurance, however, that the court will agree to such a conversion. *See id.* § 706(b).

77. 11 U.S.C. § 704(1).

78. *Id.* § 721.

79. This Article's liquidation model looks to the day of the debtor's bankruptcy petition as the date that liquidation begins. This focus should not be confused with other consequences of bankruptcy that are dependent on time criteria, such as whether secured claims continue to accrue interest post-petition, *see supra* notes 46-47, or whether secured creditors in a "cram down" are entitled to the value of their claims "as of the effective date of the [debtor's] plan [of reorganization]." 11 U.S.C. § 1129(b)(2).

80. *Cf.* 11 U.S.C. § 1129(a)(7) (codifying the "best interests of the creditor" test which prevents unsecured creditors from vetoing a reorganization plan under Chapter 11 if they receive the same distribution they would receive in a Chapter 7 liquidation). It is, of course, ironic—but not necessarily wrong—to use a liquidation test in order to balance the debtor's ability to achieve a fresh start by reorganizing. Perhaps the most apparent anomaly this test raises is the possible inconsistency with § 1111(b) of the Code, which provides that a secured creditor can protect itself from a low valuation of collateral by a reorganizing debtor by asserting a secured claim for the full amount of the debt. *See id.* § 1111(b). The analogy to § 1111(b), however, is imprecise. It addresses valuation of collateral that is indisputably subject to the secured creditor's lien, whereas § 552 addresses what collateral is subject to the lien in the first place.

we will use the term "liquidating collateral" to refer to the original collateral, and "replacement collateral" to refer to the new assets. Most collateral, such as inventory, is liquidating collateral. Even BioTech's contract with Gargantuan is liquidating collateral because each payment under the contract replaces a portion of the contract. Another example of liquidating collateral is a year-long lease.[81] Suppose the aggregate lease rentals are $1200. When the lessor receives the first month's payment of $100, the remaining rentals decrease to $1100. Under the proposed model, as is generally the case under existing law, a security interest in liquidating collateral should continue in the replacement assets.

Sometimes new assets arise during the liquidation period without the original collateral being depleted. For ease of reference we will use the term "non-liquidating collateral" to refer to that original collateral, and "non-replacement collateral" to refer to the new assets to the extent they would be subject to the floating lien under non-bankruptcy law. Should the floating lien continue on the new assets generated from non-liquidating collateral? That is a difficult question under existing law, where the inquiry of what constitutes "proceeds, product, offspring, or profits" often focuses on a "causation" test of whether new collateral is traceable to pre-petition collateral.[82] Tracing, however, is often confusing.[83] It also can lead to results that are clearly contrary to the Code's policy of debtor rehabilitation. For example, if the pre-petition floating lien covers *all* of a debtor's assets, then all assets generated post-petition are arguably traceable to pre-petition collateral. On the other hand, a secured creditor with a floating lien on less than all a debtor's assets would have more difficulty tracing new assets to pre-petition collateral. Se-

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81. For other examples of liquidating collateral, see *infra* notes 160-248 and accompanying text.

82. *See* EPSTEIN ET AL., *supra* note 1, § 6-77, at 416; *cf.* LYNN M. LOPUCKI & ELIZABETH WARREN, SECURED CREDIT, A SYSTEMS APPROACH (TEACHER'S MANUAL) 219-31 (1995) (proposing a "value tracing" theory that uses the concepts of "proceeds, products, rents, profits, and offspring" to identify particular sets of "tracing rules"). It is not entirely clear how to apply the value tracing theory in a bankruptcy. Under the theory, § 552 "permits the secured creditor to trace the value of its collateral, but it is narrower than Article 9 [partly because § 552] limits value tracing [in bankruptcy] to five concepts: proceeds, product, offspring, rents, or profits." *Id.* at 219. These, however, are the same five concepts that underlie the value tracing theory's non-bankruptcy tracing rules, *see id.* at 206, at least raising a question as to whether those concepts should be interpreted differently in a bankruptcy.

83. Professors LoPucki and Warren acknowledge that "neither the parties that use the terms [proceeds, product, offspring, or profits], nor the courts that interpret them, always agree on what the rules [for tracing proceeds, product, offspring, or profits to pre-petition collateral] are." LOPUCKI & WARREN, *supra* note 82, at 206.

cured creditors thus would be motivated to demand a pre-petition floating lien on all of a debtor's assets to minimize the post-petition tracing risk.

The Code should not, however, be interpreted to lead to such undesirable results. The liquidation model provides a solution. Rather than focusing on the phrase "proceeds, product, offspring, or profits" or attempting to trace post-petition collateral to pre-petition collateral, one should make a two step inquiry.[84] Does the new collateral replace or substitute for the existing collateral?[85] If not, would the new collateral be acquired despite the debtor's liquidation?[86] If the answer to either question is yes, then the new collateral would be subject to the floating lien; but the new collateral would be unencumbered if the answer to these questions is no.

What is gained by substituting the phrase "replace or substitute" ("RS") for § 552's phrase "proceeds, product, offspring, or profits" ("PPOP")? The distinction is not merely semantic. As shown below, RS is intended to have a more limited scope than PPOP and does *not* capture the entire litany that is captured by PPOP. RS merely expresses the concept of replacing one form of collateral with another, and therefore is more predictable. PPOP potentially goes beyond that to cover all derivative or traceable collateral.

A textual analysis shows that PPOP is a broader concept than RS. PPOP consists of four terms, only the first of which—"proceeds"—encompasses replacement collateral.[87] The remaining

84. The inquiry does not require a valuation. *See infra* text accompanying notes 148-51. This Article also assumes that the new assets would be covered by the floating lien under commercial law.

85. The phrase "replace or substitute for" should be interpreted by reference to the specific items, and not generic categories, of collateral. *See infra* notes 180-97 and accompanying text.

86. As an alternative to this second step of the inquiry, one might consider asking, by analogy to the test used under 11 U.S.C. § 362(d) for lifting the automatic stay in bankruptcy, whether the non-replacement collateral must remain unencumbered for a successful reorganization? If so, the floating lien would terminate on such collateral; if not, the lien would continue. The problem, however, with such a test is that it may be impractical to apply. *Cf. infra* notes 139-40 and accompanying text (discussing the two-point test for measuring the value of collateral).

87. Proceeds includes "whatever is received upon the sale [*i.e., replacement* by the sale proceeds], exchange [*substitution*], collection [*replacement* by the collected cash or other property] or other disposition [*replacement* by the proceeds of the disposition] of collateral or proceeds." U.C.C. § 9-306(1) (1995) (emphasis added). *See, e.g.*, Great-West Life & Annuity Assurance Co. v. Parke Imperial Canton, Ltd., 177 B.R. 843, 853 (N.D. Ohio 1994) (holding that only proceeds, and not product, offspring or profits, means converted property); *accord* Greyhound Real Estate Fin. Co. v. Official Unsecured Creditors' Comm. (*In re* Northview Corp.), 130 B.R. 543 (Bankr. 9th Cir. 1991).

terms of PPOP describe non-replacement collateral. "Product," for example, means items of collateral produced by other items of collateral without the original collateral being used up,[88] such as milk produced by a cow.[89] "Offspring" means the progeny of livestock-collateral, and therefore derives from, but does not necessarily replace or substitute for, the original livestock. Finally,[90] "profits" means the income minus expenses of a business, and therefore do not replace or substitute for the business itself. Accordingly, RS would only include the "proceeds" component of PPOP.

Because product, offspring and profits are non-replacement collateral, they are analyzed under existing law by a causation/tracing approach. In the best of circumstances, causation is difficult to pin down because causes can be either direct or indirect. The circumstances of the PPOP inquiry make causation even more difficult to determine. By focusing only on how non-replacement collateral (*i.e.*, the product, offspring, and profits) derives from non-liquidating collateral, the inquiry fails on its face to take into account the effect on the reorganizing debtor of encumbering the non-replacement collateral; and that failure can tempt the courts to narrowly construe causation to restrict encumbrances where the product, offspring and profits are the fruits of the labor of the reorganizing debtor. Perhaps that is why the courts are split on even such basic issues as whether milk is the "product" of cows.[91] This is not to say that courts cannot reach sensible results, but they often do so for the wrong reason and without articulating a normative rule of law.

PPOP's reliance on causation and its potential breadth therefore make it hard to pin down. RS, in contrast, is narrower and easier to understand. It is not, however, too narrow because the liquidation

88. This is aside from depreciation, of course. For a discussion of the relationship between the liquidation model and depreciation, see *supra* text accompanying notes 41-45.

89. Assuming, of course, that the cow itself is collateral. *See* Wilke Truck Serv., Inc. v. Wiegmann (*In re* Wiegmann), 95 B.R. 90, 93 (Bankr. S.D. Ill. 1989) (finding, where dairy cows were collateral, that milk produced post-petition and the proceeds for its sale were products in which creditor had security interest); *In re* Underbakke, 60 B.R. 705, 708 (Bankr. N.D. Iowa 1986) (same).

90. Section 552(b) originally included "rents" in the litany of PPOP (or, as it would have been called, "PPORP"). Rents were dropped when § 552 was amended in 1994 to treat rents in a special subsection. *See* Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, Tit. II, § 214(a), 108 Stat. 4106, 4126 (codified at 11 U.S.C. § 552(b)(1)-(2) (1994)). Under this Article's liquidation model, rents would not need to be separated out because they would constitute replacement collateral. *See infra* text accompanying notes 194-97.

91. *See supra* text accompanying notes 7-8. The equities exception, of course, compounds the court's discretion, making it even more difficult to predict consequences.

model adds a fallback: bankruptcy also should respect a floating lien on non-replacement collateral that would arise despite the debtor's liquidation.[92] This second test expands the concept of "replace or substitute" while avoiding the need to trace or to engage in a causation inquiry. The inquiry is therefore simplified, conceptually and in practice. Furthermore, because it focuses on collateral that would arise in liquidation, the inquiry is more consistent with debtor rehabilitation than is the PPOP inquiry under existing law.

In Part III this Article will focus on how to apply the liquidation model, including how to determine whether new assets are acquired despite a debtor's liquidation. It is first necessary, however, to evaluate the model.

II. EVALUATING THE LIQUIDATION MODEL

This Part evaluates the proposed liquidation model under which creditors with security interests in after-acquired collateral receive in a reorganization what they would receive if the debtor chose to liquidate in bankruptcy. It concludes that the model is workable and desirable because it balances fundamental policies underlying commercial law, such as fairness, consistency, simplicity of implementation, and clarity,[93] with the fresh start policy of bankruptcy.

A. *Balancing Competing Policies of Commercial Law and Bankruptcy*

The liquidation model upholds the fresh start policy of § 552 by cutting off a typical floating lien, thereby defeating the situational monopoly it otherwise would create in bankruptcy. To understand a situational monopoly, recall the floating lien that Gold Digger Credit Corp. obtained on the inventory of Jim's Jewelry Store.[94] At the time the Store filed a bankruptcy petition, its inventory was worth only a nominal amount. During the reorganization, the Store decided to

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92. *See infra* text accompanying notes 176-80 for a discussion of how to apply this second step of the liquidation model.

93. The author has derived a set of constraints from the policies and principles underlying commercial law and has suggested that these constraints would limit "ad hocery" in the private rulemaking process and would provide a basis for judging rulemaking proposals and their consequences. *See* Steven L. Schwarcz, *A Fundamental Inquiry into the Statutory Rulemaking Process of Private Legislatures,* 29 GA. L. REV. 909, 913 (1995) [hereinafter Schwarcz, *Fundamental Inquiry*]. The policies identified here are borrowed from that article.

94. For a more detailed description of the scenario, see *supra* text accompanying notes 73-74.

purchase new merchandise. To make this purchase, it needed a $150,000 line of credit, which Southwest Bank was considering offering. However, if Gold Digger's security interest extended to the new inventory, Southwest would be unwilling to finance the reorganization because it would be unable to use the new inventory to secure itself against loss.[95] Gold Digger's security interest does *not* extend to the new inventory because the underlying goods—the diamond tennis bracelets—neither replace nor substitute for the old inventory—the plastic rings—and also would not be acquired despite the Jewelry Store's liquidation.

Commentators analyzing secured debt have noted a similar situational monopoly created by a floating lien in a commercial law context.[96] Suppose that Corner Market, a grocery store, borrowed money from National Savings & Loan, which secured the loan with a floating lien on Corner Market's inventory, equipment, and other assets. Corner Market then decides it could double its profits if it buys a forklift to enable it to stock shelves more quickly. It would like to finance the purchase of the forklift from Local Bank, which is offering a lower interest rate than National. However, National's floating lien has encumbered all of Corner Market's assets, and Local will not lend unsecured. Thus, National's floating lien creates a situational monopoly because Corner Market has no collateral to offer as security to other lenders.[97]

Unrestrained situational monopolies are economically inefficient because they eliminate competition. They allow the lender who executes a floating lien to extract monopoly profits by charging above competitive rates on subsequent loans, or to impose the lender's judgment on the debtor by withholding (and therefore depriving the debtor of) new capital. Thus, commercial law has created a financing device that limits them. Professors Jackson and Kronman, in their seminal article explaining the economics of secured debt, showed that

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95. Southwest Bank's unwillingness to finance the reorganization assumes that the Store had no other significant assets and also was unable to provide Gold Digger adequate protection to allow the granting of a senior lien under 11 U.S.C. § 364(d) (1994). *Cf. infra* notes 100-35 and accompanying text (discussing fairness of the liquidation model).

96. *See* Thomas H. Jackson & Anthony T. Kronman, *Secured Financing and Priorities Among Creditors*, 88 YALE L.J. 1143, 1167 (1979).

97. *See id.* at 1158-59; *cf.* ROBERT COOTER & THOMAS ULEN, LAW AND ECONOMICS 428 (1988) (applying the situational monopoly concept in the products liability context). For an account of why, independent of monopoly profits, Local Bank can offer the debtor lower interest rates than National's rates, see Paul M. Shupack, *Defending Purchase Money Security Interests Under Article 9 of the UCC From Professor Buckley*, 22 IND. L. REV. 777 *passim* (1989).

purchase money security interests ("PMSIs") can defeat the situational monopolies that floating liens create.[98] PMSIs, which are available to creditors or vendors who provide financing for the purchase of specific property, allow these persons to obtain a security interest in that property entitled to first priority even if a secured creditor has previously perfected a floating lien on all of the debtor's after-acquired inventory.[99] Local therefore can lend Corner Market money to buy the forklift and take a first priority security interest in it. The PMSI defeats the situational monopoly by giving debtors the opportunity to acquire new collateral at competitive interest rates and creditors the opportunity to extend purchase money financing on a secured basis.

Cutting off floating liens in bankruptcy achieves a similar, although more far reaching, result. Southwest can lend Jim's Jewelry Store money to buy new inventory while it is reorganizing, and the new inventory will not be subject to Gold Digger's pre-petition floating lien. Cutting off floating liens precludes the pre-bankruptcy creditor from unilaterally undermining the reorganization by refusing to make a new loan or by charging uncompetitive interest rates. The question remains, however, whether this result is fair.

B. Fairness

Fairness is "integral to virtually all bodies of law, including commercial law."[100] Federal bankruptcy law neither overrides that principle nor militates that the law favor debtor rehabilitation without regard for fairness to secured creditors.[101] Is the liquidation model fair? We consider this question first from the standpoint of secured creditors and the debtor, and then from the standpoint of unsecured creditors.

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98. *See* Jackson & Kronman, *supra* note 96, at 1158-59. Several commentators have criticized Jackson and Kronman's theory. *See* Alan Schwartz, *Security Interests and Bankruptcy Priorities: A Review of Current Theories,* 10 J. LEGAL STUD. 1, 10-11 (1981) (arguing that the monitoring-cost theory of priority fails because it does not explain "why the secured creditor gains more from security than the unsecured creditors lose from it"); Robert E. Scott, *A Relational Theory of Secured Financing,* 86 COLUM. L. REV. 901, 902 (1986).

99. *See* U.C.C. § 9-312(3) to -(4) (1995).

100. Schwarcz, *Fundamental Inquiry, supra* note 93, at 933.

101. Federal bankruptcy law generally protects the rights of secured creditors. *See, e.g.*, 11 U.S.C. § 361 (1994) (adequate protection); *id.* § 362(d) (lifting of the bankruptcy stay); *id.* § 1111(b); *id.* § 1129(a)(7); *id.* § 1129(b)(2).

1. Fairness As Between Secured Creditors and the Debtor

It previously has been noted that when secured creditors bargain for collateral, they seek terms that thoroughly secure them against loss in the event that the debtor opts for a Chapter 7 liquidation, and they are at risk if they fail to obtain such terms.[102] The liquidation model intentionally creates, from the secured creditor's standpoint, a Chapter 7 liquidation scenario even in the event of a Chapter 11 reorganization. The goal is to allow assets that would not have been available to the secured creditor in the event of an actual Chapter 7 to be used for the debtor's Chapter 11 reorganization. This explanation begs the question, however, of whether the debtor actually needs that property in order to reorganize. Would more conventional approaches allow the debtor to reorganize, thereby avoiding the somewhat harsh cutoff of floating liens? This Article will first show that the conventional approaches are insufficient.

There are two possible conventional approaches that a reorganizing debtor might use to finance its reorganization. The first is the PMSI, discussed above.[103] The second is the debtor's post-petition borrowing powers under § 364 of the Code.[104] As shown below, neither approach by itself would necessarily be sufficient to ensure that a debtor has the financial ability to reorganize. A PMSI can be used to defeat the situational monopoly of a lender with a floating lien. Few would say that is unfair, because the property being acquired through this purchase money financing device is new to the debtor and would not have become the debtor's property but for the availability of PMSI financing. Looked at from the standpoint of the debtor's balance sheet, the PMSI adds new assets and a new offsetting liability that matches those assets.[105] The cutoff in bankruptcy of pre-petition liens is more complex, however. The liquidation model would cut off floating liens not only on newly financed assets but also on most other assets newly acquired by the debtor after bankruptcy. One therefore may question whether a "blanket" cutoff of the floating lien, as opposed to a cutoff only as needed to attract new financing, is justified. Could the PMSI priority scheme be used to

102. *See supra* text accompanying notes 79-80.

103. *See supra* notes 98-99 and accompanying text.

104. 11 U.S.C. § 364 (1994).

105. This argument assumes, however, that the newly purchased property is useful to and does not depreciate in the hands of the debtor. *Cf.* Paul M. Shupack, *Defining Purchase Money Collateral*, 29 IDAHO L. REV. 767, 773 (1992-93). In a bankruptcy, a PMSI financing would require court approval, and creditors could object if they questioned the value of the property being purchased. *See* 11 U.S.C. §§ 363-364.

attract new financing for reorganizing debtors in bankruptcy, thereby obviating the need for a blanket cutoff?

This Article does not suggest that PMSI financing would never be sufficient to allow debtors to finance their reorganizations. However, given that PMSI financing is limited to facilitating asset purchases[106] and, therefore, is only a small portion of corporate financing outside of bankruptcy,[107] this Article assumes that more than PMSI financing generally would be needed.

Would the debtor's power to obtain post-petition secured financing under § 364 of the Code be sufficient to finance its reorganization? Section 364 provides that a bankruptcy court, after notice and a hearing, may authorize the debtor to obtain post-petition financing by granting the new lender priorities over other unsecured financing;[108] and if the debtor is unable to obtain post-petition financing merely through granting priorities, it may grant a lien on unencumbered property[109] or a junior lien on encumbered property.[110] If these methods of obtaining post-petition financing still fail, the bankruptcy court may authorize the debtor to grant the new lender a senior or *pari passu* lien on property *already subject to a lien*, but only if the original secured lender is given adequate protection to protect its collateral interest.[111]

With all these techniques available to finance the debtor's reorganization, is a bankruptcy cutoff of floating liens still needed? The answer is a qualified yes. Consider, for example, a floating lien on all of a debtor's assets. If the debt secured by the floating lien approximates or exceeds the value of the collateral, then § 364 would not help the debtor. Assume that the debtor would be unable to obtain unsecured financing by offering a priority over other unsecured financing, and the prospective new lender insists on a lien. However, there would be no unencumbered property on which to grant a lien, and (given our assumption that the existing debt exceeds the collat-

106. *See* U.C.C. § 9-107 (1995).

107. Most corporate financing is done on an unsecured basis, as opposed to a secured basis. *See* Ronald J. Mann, *Explaining the Pattern of Secured Credit*, 110 HARV. L. REV. (forthcoming 1997) (manuscript at 7, on file with author). Professor Mann confirms by empirical observation that "secured credit [is] relatively rare" for strong firms. *Id.* PMSI financing is merely a subset of secured financing.

108. *See* 11 U.S.C. § 364(b), (c)(1).

109. *See id.* § 364(c)(2).

110. *See id.* § 364(c)(3).

111. *See id.* § 364(d). Section 364(d) provides another way to defeat a secured lender's situational monopoly by allowing a new lender to be secured by collateral otherwise belonging to the original lender *if* the original lender is protected.

eral value) a junior lien would have no value. Therefore, to obtain post-petition financing, the debtor would have to offer the prospective new lender a senior or *pari passu* lien on property already subject to the floating lien. It could not, however, do that under § 364 unless the original secured lender were given adequate protection.

Adequate protection generally requires that the debtor make cash payments or give additional or replacement collateral to the original secured lender.[112] A debtor might not, however, have surplus cash, and it may not be able to give additional or replacement collateral if all of its property is already pledged under the floating lien to the original lender. If the debtor cannot provide the original lender with adequate protection, it will not be able to grant a senior or *pari passu* lien to coax post-petition financing from the new lender. However, a bankruptcy cutoff of floating liens can avoid the need to give the original lender adequate protection: collateral that no longer is covered by the floating lien is freely useable by a debtor in its reorganization.

The analysis now returns to whether the bankruptcy cutoff of floating liens would be unfair to creditors secured by those liens. This Article maintains that it is *not* unfair to creditors secured by those liens *so long as* the security interests of those creditors are protected under the liquidation model of this Article. In a commercial law context, fairness

> helps to preserve expectations by ensuring that parties are governed by neutral rules. In more limited circumstances,

112. *See id.* § 361(1)-(2). Adequate protection also would include "granting such other relief . . . as will result in the realization by [the original secured lender] of the indubitable equivalent" of the collateral pledged to the new lender. *Id.* § 361(3). There are, however, some cases holding that the adequate protection requirement need not prevent a debtor with a viable business from reorganizing. If the court believes the business is viable, a post-petition lien on the ongoing business may itself constitute adequate protection to pre-petition secured creditors. *See* Provident Bank v. BBT (*In re* BBT), 11 B.R. 224, 237 (Bankr. D. Nev. 1981).

Where *less* than all of a debtor's property is pledged, the debtor may be able to grant additional or replacement collateral from its unencumbered assets. Also, where the debt secured is significantly less than the value of the pledged property, the prospective new lender may consider taking a junior lien on existing collateral. However, to draw a distinction in the application of § 552 based on these factual variations would confuse the law. It also would lead to the anomalous and disturbing result that a lender who takes a floating lien would have an incentive to minimize the amount of financing provided to the debtor because only where the financing is small compared to the collateral value would the debtor be assured of having surplus collateral on which to give junior liens under § 364(c)(3)—thereby discouraging a cutoff under § 552. A better solution, we believe, is to find a more generic approach to § 552 that facilitates post-petition financing while being fair to secured creditors.

> fairness also can mean that the law should protect weaker parties, such as those with less bargaining power; that opportunistic behavior should be prevented in circumstances that could not have been contemplated in advance; and that implicit rules of conduct should be recognized if they arise from widespread courses of dealing in an industry or from particular courses of dealing between specific parties.[113]

It is assumed in this Article that the secured party with a floating lien is not a "weaker" party, given that it had sufficient negotiating power to obtain the floating lien. And the balance between floating liens and the bankruptcy cutoff neither reflects a widespread course of dealing (otherwise this Article would be unnecessary) nor, given its genesis from a debtor's bankruptcy filing, does it reflect a particular course of dealing between the secured party and the post-petition debtor's trustee-in-bankruptcy.[114]

The liquidation model also preserves reasonable expectations. As has been discussed, a secured creditor cannot always rely on taking as collateral future assets whose existence depends on a bankrupt debtor's continuing in business. Future collateral is speculative because the debtor may cease doing business and liquidate.[115] The floating lien of UCC section 9-204 was never intended to grant a secured creditor a right to speculative collateral.[116] So long as the secured creditor's floating lien continues pursuant to the liquidation model of this Article, the secured creditor receives a bargain that

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113. Schwarcz, *Fundamental Inquiry*, *supra* note 93, at 913 n.7 (citation omitted).

114. The post-petition debtor and its trustee-in-bankruptcy are different legal entities than the pre-petition debtor.

115. *See* 11 U.S.C. § 301 (1994); *cf. id.* § 706 (allowing conversion to a case under chapter 11, 12 or 13 to chapter 7); *see also supra* notes 75-76 (discussing chapter 7 liquidation and chapter 11 reorganization). One may argue that taking future collateral in a debtor that is a going concern should not be speculative because the expectation is that the debtor's business will continue. If, however, this expectation is reasonable because the debtor has a strong business, then it is unlikely that the debtor will become the subject of a bankruptcy case in the first place, the pre-condition for applying § 552. On the other hand, if the debtor has a weak business, its chance of bankruptcy is higher and then the expectation may not be entirely reasonable. Therefore the stronger the debtor, the less reasonable this expectation but the less likely it is that § 552 will apply; whereas the weaker the debtor, the more reasonable this expectation and the more likely it is that § 552 will apply. Nonetheless, one still may argue that the floating lien could have been taken when the debtor's business is strong. However, that argument is not compelling because creditors only tend to demand collateral from weak debtors. See Mann, *supra* 107 (manuscript at 7). Ultimately one must recognize there may be individual cases where a creditor's reasonable expectations *would* be impaired by this Article's liquidation model. But that is a necessary cost of balancing competing commercial law and bankruptcy policies.

116. *See* U.C.C. § 9-204 cmt. 2 (1995).

ought to have been within its range of reasonable expectations.

One may ask whether a model that artificially assumes a debtor's liquidation is fair to a creditor with a floating lien if the debtor successfully reorganizes in bankruptcy. A related question is whether the model works if a solvent company were to file for bankruptcy.[117] In these cases, one might argue that limiting the creditor to assets acquired in a liquidation could lead to abuse of the bankruptcy laws. Companies are rational maximizers and might limit the amount it costs them to borrow money by filing for bankruptcy when they have little after-acquired property in their possession. The answer to both questions is that the model works because the Code protects unsecured as well as secured creditors.[118] If the collateral value does not cover the creditor's loan, the creditor has an unsecured claim under present law for the amount of the deficiency.[119] If the company is solvent, the creditor should be able to collect its full claim.[120]

A cutoff of the floating lien as to assets generated by the debtor's ongoing business is not only fair to secured creditors but also may be necessary to afford a debtor an opportunity to try to reorganize in bankruptcy and achieve a fresh start. The first courts to

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117. Although many companies that file for bankruptcy are insolvent, solvent companies can and sometimes do file. Consider, for example, the filings by Dow Corning, Texaco, and Johns-Manville. *See In re* Dow Corning Corp., 198 B.R. 214 (Bankr. E. D. Mich. 1996); *In re* Texaco, Inc., 109 B.R. 609 (S.D.N.Y. 1989) (filing resulted from $10.5 billion verdict against Texaco which Texaco was appealing); *In re* Johns-Manville Corp., 68 B.R. 618 (S.D.N.Y. 1986), *aff'd in part, rev'd in part*, 78 B.R. 407 (S.D.N.Y. 1987), *aff'd sub nom.* Kane v. Johns-Manville Corp. (*In re* Johns-Manville Corp.), 843 F.2d 636 (2d Cir. 1988). The Code does not bar solvent companies from filing because it provides no financial standards for filing a voluntary petition. *See also* 11 U.S.C. § 301 (providing for voluntary cases under Chapter 11); Chaim J. Fortgang & Lawrence P. King, *The 1978 Code: Some Wrong Policy Decisions*, 56 N.Y.U. L. REV. 1148, 1160 (1981) (stating that "[i]n the context of very large chapter 11 cases, depending on the length of the proceedings, solvency may not be terribly unlikely").

118. The Code consistently protects creditors from debtors who try to abuse it. For example, to prevent debtors from denying unsecured creditors the time value of their money, the Code has adopted the "best interests of the creditors" test in § 1129(a)(7). *See* 11 U.S.C. § 1129(a)(7) (1994). This provision requires that impaired creditors receive at least what they would get in a Chapter 7 liquidation. In a Chapter 7 bankruptcy, if the estate is solvent after all of the claims have been satisfied, the debtor must pay unsecured creditors post-petition interest at the legal rate from the date that the petition was filed on their claims. *See id.* § 726(a)(5). Thus, in a reorganization, impaired creditors must get post-petition interest on their claims if the debtor is solvent. Fortgang and King have noted that the debtor may have some room to deny creditors the time value of their money insofar as the legal rate of interest is different from the contract rate for which the creditor bargained. *See* Fortgang & King, *supra* note 117, at 1151-53.

119. *See* 11 U.S.C. § 506(a) (1994).

120. The potential for abuse also will be limited by reputation. Creditors will be wary about making loans to a company that has previously filed for bankruptcy in bad faith.

recognize the Code's fresh start policy, the discharge of financial obligations in exchange for nonexempt assets, applied it to individuals, not to corporations.[121] However, since the early cases were decided, the fresh start policy has been applied to corporations as well. As Professor Block-Lieb has stated, "[b]y encouraging debtors to file voluntary petitions before they either become insolvent or are unable to pay debts as they come due, Congress sought to . . . facilitate the rehabilitation of financially troubled business debtors."[122]

After-acquired property can be crucial to a reorganization. Debtors need to pay employees, retool factories, explore new product lines. Obtaining capital can be expensive because prospective lenders may see the reorganizing debtor as a credit risk and thus demand a high rate of interest; indeed, they may conclude that the debtor is such a risk that they cannot make a loan at all. To the extent that after-acquired property can be freed from the speculative impact of floating liens, the debtor will have a greater opportunity to reorganize.

2. Fairness to Unsecured Creditors

Lastly, we examine fairness from the standpoint of unsecured creditors—particularly involuntary creditors who had no opportunity to bargain and are, effectively, subordinated to creditors with floating liens. To some extent, this raises the ongoing controversy of whether security interests themselves are fair to unsecured creditors.[123] This Article does not purport to resolve that controversy but merely notes

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121. Notably, *Local Loan Co. v. Hunt*, 292 U.S. 234, 244 (1934), which is often cited as the case that established the availability of the fresh start to *all* debtors, made the fresh start available to an individual, not a corporation. Other early cases also made the fresh start available to individuals, not corporations. *See* Williams v. United States Fidelity & Guar. Co., 236 U.S. 549, 554-55 (1915); Wetmore v. Markoe, 196 U.S. 68, 77 (1904).

European countries have never championed the fresh start doctrine. *See* J.H. DALHUISEN, 1 DALHUISEN ON INTERNATIONAL INSOLVENCY AND BANKRUPTCY § 1.01[1] (1986). Instead, they have used bankruptcy laws as a collection mechanism for creditors. Despite the recent trend in the Netherlands, Belgium, France, and Italy of using short judicial stays to give corporate debtors a chance to regroup, see *id.*, European legislators have been unwilling to create a right of legal discharge for debtors or a statutory scheme for corporate reorganization.

122. Susan Block-Lieb, *Fishing in Muddy Waters: Clarifying the Common Pool Analogy as Applied to the Standard for Commencement of a Bankruptcy Case*, 42 AM. U. L. REV. 337, 424 (1993).

123. *See* David Gray Carlson, *On the Efficiency of Secured Lending*, 80 VA. L. REV. 2179, 2179-81 (1994); Schwartz, *supra* note 98, at 33-37; Scott, *supra* note 98, at 904-12; Paul M. Shupack, *Solving The Puzzle of Secured Transactions*, 41 RUTGERS L. REV. 1067, 1073-85 (1989).

that security interests have been around for thousands of years,[124] and a technique that endures time and experience should not be rejected without a compelling reason. Whether pure theory can provide that compelling reason is at least questionable.

Furthermore, scholarly articles[125] addressing the secured credit controversy do not always distinguish between pre-existing creditors receiving security for antecedent debt—in which case "the granting of security reduces the assets on which the remaining unsecured creditors can levy and thereby increases the risk for such unsecured creditors"[126]—and the situation where lenders "offer new money at lower interest rates in return for security."[127] In the latter case, the granting of security does not necessarily reduce the assets on which unsecured creditors can levy because the debtor receives the loan proceeds. To the extent the law is concerned with the debtor misusing those proceeds, that concern is more appropriately governed by fraudulent conveyance and preference laws.[128]

Floating liens should be analyzed using the same distinction between liens securing antecedent debt and those given in order to attract new money. The following discussion will focus on the latter case, where the floating lien is granted not to secure an existing debt but rather to enable the debtor to borrow new funds. Even in that case, however, floating liens exacerbate the fairness controversy over secured credit because of their seemingly insidious nature of attaching to assets not yet in existence. Voluntary creditors will be alerted

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124. *See, e.g., Deuteronomy* 24:10-13 (discussing the pledge by a poor man of his cloak).

125. *See* Barry E. Adler, *An Equity-Agency Solution to the Bankruptcy-Priority Puzzle*, 22 J. LEGAL STUD. 73 (1993); 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); F.H. Buckley, *The Bankruptcy Priority Puzzle*, 72 VA. L. REV. 1393 (1986); Carlson, *supra* note 123; Harris & Mooney, *supra* note 63; Jackson & Kronman, *supra* note 96; Schwartz, *supra* note 98; Scott, *supra* note 98; Shupack, *supra* note 123; James J. White, *Work and Play in Revising Article 9*, 80 VA. L. REV. 2089 (1994).

126. *See* Schwarcz, *Alchemy*, supra note 25, at 148 n.52.

127. *See id.* at 148 n.52. *See generally* Steven L. Schwarcz, The Easy Case for the Priority of Secured Claims in Bankruptcy: A Response to Professors Bebchuk and Fried *passim* (work in progress, on file with author) [hereinafter Schwarcz, *Easy Case*] (arguing that an analysis of the priority of secured claims not only must distinguish new money liens from liens securing antecedent debt but also must recognize that in an imperfect universe there is a distinction between the *use* of secured credit and the *availability* (and use only if needed for liquidity) of secured credit).

128. A secured creditor also may have an obligation in limited circumstances to monitor the debtor's use of proceeds. *See* Schwarcz, Easy Case, *supra* note 127, at 11-15.

to this when extending credit by searching UCC filing records,[129] and they can impose covenant restrictions on the debtor's creation of floating liens or else price their loans accordingly. Involuntary creditors, however, can do neither. It is the drama of seeing a debtor's newly arising assets being inexorably attached by the floating lien that creates the perception of unfairness. That drama, however, is more a soap opera than a tragedy. The creditor with a floating lien can never receive more from the collateral than its principal and accrued interest.[130] The surplus collateral will be available to repay unsecured creditors, including any involuntary creditors. Furthermore, and this is most significant, a floating lien, *even one securing new money*, may be subject to bankruptcy preference law.[131] Preference law is intended to assure equality of distribution of a debtor's estate to all creditors, including unsecured creditors. It does that by various means, including voiding transfers of collateral made, and floating liens on assets coming into existence, within ninety days of an insolvent debtor's bankruptcy.[132] Because floating liens are subject to the same bankruptcy policy that governs other prebankruptcy transfers, they are not *per se* unfair to unsecured creditors.

Preference law would not apply if the debtor were solvent at the time the transfer of collateral occurs[133]—in the case of floating liens, at the time of the acquisition of the asset to which the lien attaches. However, a solvent debtor by definition has sufficient assets to pay its

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129. *See* U.C.C. § 9-302 (1995).

130. *See id.* § 9-502(2). Reasonable expenses are also allowed. *See id.* § 9-504(1)(a).

131. *See* 11 U.S.C. § 547 (1994). That is because a floating lien secures a loan already made. Of course, some items of collateral may become subject to the floating lien within days or weeks of the making of the loan and therefore qualify for the § 547(c)(1) exemption as a "contemporaneous exchange for new value." *Id.* § 547(c)(1)(a). However, most items of collateral covered by the floating lien would be expected to arise after that time.

There is some ambiguity whether after-acquired collateral arising in the debtor's ordinary course of business is subject to preference law. U.C.C. § 9-108 provides that a "security interest in ... after-acquired collateral shall be deemed to be taken for new value and not as security for an antecedent debt if the debtor acquires his rights in such collateral ... in the ordinary course of his business ...." U.C.C. § 9-108 (1995). Federal preference law, however, appears inconsistent with state commercial law. While § 547(b) covers "any transfer" of an interest in property made within 90 days of an insolvent debtor's bankruptcy and § 547(e)(3) provides that a transfer is not made until the debtor has rights in the property, § 547(c)(5) exempts floating liens on inventory and receivables that do not improve the secured party's position prior to bankruptcy. *See* 11 U.S.C. § 547. Taken together, these bankruptcy law sections suggest that floating liens on inventory and receivables that do improve the secured party's position, and floating liens on other types of collateral (such as equipment), *would* be subject to preference law. *See infra* discussion in notes 136-44 and accompanying text.

132. *See* 11 U.S.C. § 547(b).

133. *See id.* § 547(b)(3).

liabilities.[134] So long as the debtor is solvent, unsecured creditors, including involuntary creditors, will not be prejudiced by the floating lien.[135]

C. Consistency

The liquidation model is consistent not only with the Code's fresh start policy but also with analogous sections of the Code. Consistency is crucial because "the lack of internal consistency ... in [a] statute ... is the best possible assurance that in the long run construction will not be uniform."[136]

Section 547(c)(5) of the Code[137] is particularly instructive because it deals with the pre-bankruptcy transfer of property secured by a floating lien. As Professor Baird states:

The prospect of a bankruptcy case might have the effect of

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134. The Code even includes contingent liabilities in making the determination of insolvency. *See id.* § 101(5), (12), (32).

135. *See* Steven L. Schwarcz, *Rethinking a Corporation's Obligations to Creditors*, 17 CARDOZO L. REV. 647, 663-68 (1996). For a contrary view, see Lynn M. LoPucki, *The Unsecured Creditor's Bargain,* 80 VA. L. REV. 1887, 1896-1923 (1994).

136. David Mellinkoff, *The Language of the Uniform Commercial Code*, 77 YALE L.J. 185, 225 (1967). Although Mellinkoff discusses consistency within the UCC, his comments are equally applicable to other statutes. *See also* Schwarcz, *Fundamental Inquiry, supra* note 93, at 940-44 (noting the importance of consistency between commercial law and related bodies of law).

137. The text of § 547(c)(5) provides:

(c) The trustee may not avoid under this section a transfer—

...

(5) that creates a perfected security interest in inventory or a receivable or the proceeds of either, except to the extent that the aggregate of all such transfers to the transferee caused a reduction, as of the date of the filing of the petition and to the prejudice of other creditors holding unsecured claims, of any amount by which the debt secured by such security interest exceeded the value of all security interests for such debt on the later of—

(A)(i) with respect to a transfer to which subsection (b)(4)(A) of this section applies, 90 days before the date of the filing of the petition; or

(ii) with respect to a transfer to which subsection (b)(4)(B) of this section applies, one year before the date of the filing of the petition; or

(B) the date on which new value was first given under the security agreement creating such security interest...

11 U.S.C. § 547(c)(5). For general discussions of § 547(c)(5), see BAIRD, *supra* note 12, at 181-85; Neil B. Cohen, *"Value" Judgments: Accounts Receivable Financing and Voidable Preferences Under the New Bankruptcy Code*, 66 MINN. L. REV. 639 (1982); Note, *Trustees Do It Better: Analyzing Section 547(c)(5) of the Bankruptcy Code*, 105 HARV. L. REV. 1285 (1992). The analogy between § 547 and § 552, although tempting, is imprecise because the conceptual basis of § 547 (avoiding preferential transfers) is equality of distribution among creditors whereas the conceptual basis of § 552 is facilitating a debtor's right to a fresh start.

> accelerating and exacerbating the creditors' race to the assets. In order to solve this gun-jumping problem, we need a bankruptcy rule that has the effect of turning back the clock and returning people to the positions they were in before bankruptcy was on the horizon.[138]

To this end, § 547(c)(5) "codifies [an] improvement in position test."[139] When the secured party is not an insider, the trustee measures the value of the collateral and the amount of the debt on two dates: (1) ninety days before the debtor files the bankruptcy petition; and (2) the day the debtor files the petition. Using this two-point test, the trustee first determines whether the collateral is worth less than the debt ninety days before the debtor files the petition. Then she determines whether the gap between the debt and the collateral has decreased because the debtor has transferred assets to the creditor in satisfaction of the debt. The trustee will find that the debtor has made a preferential transfer if an undersecured creditor's position improved, to the prejudice of unsecured creditors, during the ninety day period.[140]

Commentators have struggled to explain § 547(c)(5)'s mechanical rule.[141] Many have emphasized that the drafters wanted to keep secured creditors from getting "too much."[142] When he was sitting with the First Circuit, Justice Breyer wrote an opinion explaining when secured creditors get too much under § 547(c)(5):[143]

> [Section 547(c)(5)] protects new receivables from preference challenges . . . only insofar as they *substitute* for old ones. Insofar as the grant of a security interest in the new collateral (receivables or inventory that comes into existence during the preference period) *improves* the creditor's position (compared to his position at the beginning of the preference period), the grant of security constitutes a preference to the extent of the improvement.[144]

Under this reasoning, the creditor that secures itself with a

138. BAIRD, *supra* note 12, at 165.

139. S. REP. NO. 95-989 at 88 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5874; *see also* H.R. REP. NO. 95-595 at 373-74 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6329-30.

140. *See* 11 U.S.C. § 547(c)(5).

141. *See, e.g.*, Thomas H. Jackson, *Avoiding Powers in Bankruptcy*, 36 STAN. L. REV. 725, 774-77 (1984); *see also* Note, *supra* note 137, at 1289-92 (stating that the application of § 547(c)(5) often leads to contradictory results).

142. *See, e.g.*, Theodore Eisenberg, *Bankruptcy Law in Perspective: A Rejoinder*, 30 UCLA L. REV. 617, 630 (1983).

143. *See* Braunstein v. Karger (*In re* Melon Produce, Inc.), 976 F.2d 71 (1st Cir. 1992).

144. *Id.* at 75.

floating lien gambles that the debtor will have enough inventory and receivables at any time to cover any loss the creditor may suffer. When bankruptcy is imminent and the creditor has lost its gamble, it should have to compete with unsecured creditors for the amount of its undersecured claim. In the absence of § 547(c)(5), the creditor may have been able to coerce the debtor on the eve of bankruptcy to increase the inventory or transfer assets in order to decrease the creditor's losses. Congress precludes secured creditors from obtaining this improvement at the expense of unsecured creditors. The liquidation model proposed in this Article therefore is consistent with § 547(c)(5) in that it precludes secured creditors from improving their position at the expense of a debtor's right to a fresh start.

D. Simplicity of Implementation

In addition to being fair to both debtors and creditors and consistent with the policies underlying the Code, the proposed model is relatively simple to implement. Simplicity of implementation has two aspects: "First, it should be simple to understand how to apply commercial law. In this sense, simplicity is related to the principle of clarity,[[145]] which maintains that the law should be straightforward, unambiguous, and clear. Second, the implementation of commercial law should be practical and cost-effective."[146]

The liquidation model addresses both these aspects. It provides an intuitive and common sense approach by which parties can balance floating liens with the bankruptcy cutoff. Nonetheless, it may not always be obvious how to determine whether particular items of non-replacement collateral would arise in a debtor's liquidation. Ultimately, that will be a question of fact for the judge. The applications section of this Article,[147] however, will show that determination is practical and cost-effective in most cases.

When evaluating the liquidation model, one also might ask whether it would be even simpler to propose a variation on the model that pays the secured creditor the liquidation value of its pre-petition collateral.[148] Such a model would be misplaced, however. *The focus*

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145. Discussed *infra* in text accompanying note 152.

146. Schwarcz, *Fundamental Inquiry*, *supra* note 93, at 939 (citations omitted).

147. *See infra* notes 160-248 and accompanying text.

148. After all, liquidation valuation, such as the so-called "best interests" test in bankruptcy, *see* 11 U.S.C. § 1129(a)(7) (1994), is easier to determine than going concern valuation, such as under the "cramdown" test in bankruptcy. *See id.* § 1129(b)(2). Under the former, one need only value the collateral, not the entire company. *See* Peter V. Pantaleo & Barry W. Ridings, *Reorganization Value*, 51 BUS. LAW. 419, 420-27 (1996).

under bankruptcy's cutoff of floating liens is not on the value of post-petition collateral but rather on which post-petition assets are encumbered by the pre-petition floating lien. A liquidation value model also would fail to recognize non-replacement collateral, which is not in existence at the time of bankruptcy. Furthermore, liquidation valuation would be inconsistent with bankruptcy law, which generally gives secured creditors a secured claim equal to the *non*-liquidation value of the collateral,[149] and also allows a secured creditor in a Chapter 11 reorganization who believes even this valuation is too low to elect to have its claim treated as a secured claim for the entire amount of the debt.[150] The task is therefore to *identify* the post-petition collateral, and that is the role of the liquidation model proposed by this Article. It may, or may not, later be necessary to value that collateral.[151]

E. Clarity

The liquidation model also would bring clarity to an area of law that is profoundly ambiguous. "Clarity is important to minimize mistakes, ambiguities, and resulting disputes and litigation. Clarity also helps to preserve expectations, which is essential to market transactions . . . [and] minimizes misinterpretations by judges and practitioners."[152]

To some extent, the need for clarity would override any arguments that the liquidation model either is too pro-creditor or too pro-debtor. Ambiguity is a worse alternative if creditors cannot rely on their floating liens and are compelled to price their loans accordingly. The liquidation model enables the parties to understand their rights and therefore more accurately price the transaction.

III. COMPARISON OF PROPOSAL AND EXISTING LAW

This Part examines § 552 of the Bankruptcy Code, the provision of federal law governing after-acquired collateral in bankruptcy, and the case law construing it.[153] It shows that the existing case law is

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149. *See* 11 U.S.C. § 506(a) (1994).

150. See *id.* § 1111(b), which overrides § 506(a).

151. *See, e.g., id.* §§ 1129(a)(7), 1129(b)(2).

152. Schwarcz, *Fundamental Inquiry*, *supra* note 93, at 928 (footnotes omitted).

153. For other articles discussing § 552, see Craig H. Averch, *The Heartbreak Hotel for Secured Lenders: When Postpetition Revenue from a Hotel is Not Subject to a Prepetition Security Interest*, 107 BANKING L.J. 484, 484-90 (1990) (arguing that bankruptcy courts should not treat hotel revenues differently from other income-producing real property and that these revenues are proceeds within the meaning of § 552(b)); R. Wilson Freyermuth, *Of Hotel Revenues, Rents, and Formalism in the Bankruptcy Courts: Implications*

sometimes confusing and disjointed. This Part also applies the liquidation model, and shows that it would help to bring order and predictability. Annex B summarizes the differences in outcomes discussed in this Article between existing law and the liquidation model.

A. *Section 552*[154]

Recall that § 552(a) cuts off floating liens in bankruptcy,[155] while § 552(b) preserves security interests in "proceeds, product, offspring, or profits" of property secured pre-petition.[156] In the legislative history of § 552, Congress explained that "[t]he term 'proceeds' ... covers any property into which property subject to the security interest is converted."[157] It also stated that § 552(b) "cover[s] the situation where raw materials, for example, are converted into inventory, or inventory into accounts. . . ."[158]

Thus, § 552 superficially appears consistent with the model insofar as it cuts off floating liens and defines proceeds as substituting for the property secured pre-petition. Discrepancies between § 552 and the model arise, however, because ambiguities[159] in § 552 together with § 552(b)'s equities exception allow bankruptcy courts great latitude. One can read § 552 to cut off floating liens on assets that substitute for existing collateral, or to enforce such liens on all of a bankrupt debtor's derivative assets, no matter how remote. The cases discussed below are illustrative of the problem, and the solution provided by the model.

B. *Case Law Categories*

This subpart discusses the categories of case law construing § 552

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for Reforming Commercial Real Estate Finance, 40 UCLA L. REV. 1461, 1467 (1993) (arguing that monies paid by commercial occupants are proceeds of the commercial real estate development and should be protected in bankruptcy under § 552(b)); Philip L. Kunkel, *Farmers' Relief Under the Bankruptcy Code: Preserving the Farmers' Property*, 29 S.D. L. REV. 303, 328-32 (1984) (briefly describing the impact of § 552(b) on security interests in the proceeds of crops, milk); Jeffrey L. Tarkenton, *Proceeds in Bankruptcy:* United Virginia Bank v. Slab Fork Coal Company, 89 W. VA. L. REV. 783, 785 (1987) (examining the *Slab Fork* decision and predicting its effect on the financing of coal companies).

154. For the text of § 552, see *supra* note 6.

155. *See* 11 U.S.C. § 552(a) (1994); WHITE & SUMMERS, *supra* note 48, § 23-6.

156. *See* 11 U.S.C. § 552(b).

157. H.R. REP NO. 95-595, at 377 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6333.

158. *Id.; see also* S. REP. NO. 95-989, at 91 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5877.

159. Congress did not define the terms "product, offspring, [and] profits." The UCC likewise does not define these terms.

and explains how the outcomes would differ under the model. The reader should note that the outcomes *also* may differ in light of the difference between the liquidation model and the "equities exception," discussed in Part III.C of this Article.

1. Dividends

The best-known case considering the treatment of dividends[160] under § 552 is *In re Hastie*.[161] In *Hastie*, Acquisition Management, a successor-in-interest of the FDIC, acquired a security interest in stock and any future dividends of the stock owned by the debtor, Hastie. The FDIC perfected its interest in the stock by taking possession of the certificated and registered securities. After Hastie filed for bankruptcy, the issuer of the stock continued to pay cash dividends to the registered owner, Hastie. Because the FDIC had not perfected its interest in the dividends, it claimed that its perfected security interest in the stock extended to the dividends as proceeds of the stock.[162] Hastie argued that the dividends were not proceeds, and therefore he should be allowed to use the dividends in his reorganization.

The Tenth Circuit held that the FDIC could prevail only if its security interest in the dividends was perfected in accordance with state law. The dividends would be perfected if they constituted proceeds under state law.[163] According to the court, however, the dividends did not constitute proceeds because the UCC (the applicable state law) definition of proceeds in section 9-306(4) "describes an event whereby one asset is disposed of and another is acquired as its substitute."[164] Cash dividends "bear[] no resemblance to the events

160. On the related issue of stock splits, see *FDIC v. Whitaker (In re Whitaker)*, 18 B.R. 314, 316 (Bankr. D. Kan. 1982) (holding that "when a creditor takes a security interest in shares of stock it is a fair inference that he intends that his security interest continue in the additional shares from a stock split, so that he may retain a security interest in the same proportionate interest in the corporation."). However, *Whitaker* portended the problems with floating liens on dividends when it distinguished the stock split from dividends: "[A] stock split is an accounting device, not a distribution of corporate earnings, like a cash or stock dividend." *Id.*

161. 2 F.3d 1042 (10th Cir. 1993); *see* Gerald T. McLaughlin & Neil B. Cohen, *A Proceeds/Profit Puzzle*, N.Y.L.J., Jan. 12, 1994, at 3.

162. *See Hastie*, 2 F.3d at 1043-44 (discussing the FDIC's claim that cash dividends were proceeds of the stock). Recall that this Article uses the term "floating lien" broadly to include post-petition collateral consisting of proceeds of pre-petition collateral. *See supra* note 2.

163. *See Hastie*, 2 F.3d at 1045-46. Under state law, the cash dividends were not separately perfected. *See id.* at 1047.

164. *Id.* at 1045.

specified in the definition of proceeds or to an act of disposition generally."[165] While "the cash dividend distributes assets of the corporation, it does not alter the ownership interest represented by the stock. [Thus, it] is not a disposition of the stock."[166]

The *Hastie* opinion is confusing because the court appears undecided whether its decision is based on state perfection law or on § 552 of the Code.[167] To the extent *Hastie* turned solely on the state law perfection issue, its significance is limited because the FDIC could have separately perfected its security interest in the cash dividends under state law.[168] Viewing *Hastie* from the standpoint of § 552, however, raises several interesting issues. Assuming the perfection under state law of the FDIC's floating lien on the dividends, would such a lien have applied to the dividends under bankruptcy law? The answer is ambiguous under the current text of § 552(b): "[I]f the [pre-petition] security interest ... extends to ... proceeds, product, offspring, or profits of [pre-petition] property, then such security interest extends to such proceeds, product, offspring, or profits acquired by the estate after the commencement of the case ...."[169]

The dilemma is that a floating lien usually applies to the debtor's existing and future assets and their proceeds. The litany of derivative products listed by § 552 neither corresponds to language used in the UCC nor, under the UCC, would need to be described in the security agreement because of the broad floating lien permitted by section 9-204.

The better view of *Hastie*[170] would appear to be that, if perfected, the FDIC's lien should have applied to the dividends under bankruptcy law. From the standpoint of state law, the dividends clearly would be covered by the floating lien on future assets.[171] And from the standpoint of bankruptcy law, § 552(b)'s broad categories of

165. *Id.*

166. *Id.* at 1046.

167. *Compare id.* at 1043 ("The issue in this case is whether a perfected security interest in ... stock continues in cash dividends paid on that stock under the Uniform Commercial Code...."), *with id.* at 1044 ("The threshold issue in this case is whether after-acquired property [cash dividends] is subject to a pre-petition security interest under bankruptcy law.") (citing 11 U.S.C. § 552 (1994)).

168. The trustee in bankruptcy can avoid an unperfected security interest. *See* 11 U.S.C. § 544 (1994). The FDIC could have perfected, for example, by recording stock ownership in its name. *See Hastie*, 2 F.3d at 1047. Furthermore, the UCC governing body is considering a change to U.C.C. § 9-306(1) to expand the definition of "proceeds" to include, among other things, stock dividends. *See* PEB REPORT, *supra* note 58, at 106-07.

169. 11 U.S.C. § 552(b)(1).

170. This assumes state law perfection.

171. *See* U.C.C. § 9-204 (1995).

"product" and "profits" arguably would cover stock dividends irrespective of whether dividends constitute "proceeds," which the *Hastie* court held they did not.[172]

Using the liquidation model of this Article to analyze the problem, one should first ask whether the dividends substitute for or replace the stock. This question poses a problem with stock because the asset represented by the stock—an ownership interest in a corporation[173]—is not necessarily the same as the corporation's underlying assets. Nonetheless, by analogy to depreciating collateral, one can hypothesize the following test. If payment of the dividend would plainly reduce the stock's value, then the dividend substitutes for a portion of the stock and, accordingly, the floating lien should encumber the dividend. A "liquidating dividend," constituting a distribution of assets to shareholders by a company in liquidation, is an obvious example of a dividend that substitutes for a portion of the stock.[174]

Payment of a dividend could plainly reduce the value of stock in other circumstances. If one holds stock in a privately owned company—that is, a company whose stock is not publicly traded so the stock value essentially represents the underlying asset value plus the company's good will—the separation between the stock and the underlying assets is somewhat transparent. Payment of a dividend would plainly reduce the amount of underlying assets, and therefore the value of the stock. The dividend again would substitute for a portion of the stock, and the floating lien should attach to the dividend.

Stock of privately owned companies, and of companies in liquidation, therefore constitutes liquidating collateral, and dividends of such stock would be replacement collateral. On the other hand, stock of publicly traded companies is not so clearly liquidating collateral because payment of an ordinary dividend on publicly traded stock does not necessarily reduce the stock's value by the amount of the dividend.[175] Although payment of a dividend technically diminishes

172. *See Hastie*, 2 F.3d at 1045-46.

173. *See id.* at 1046.

174. *See* Aycock v. Texas Commerce Bank, 127 B.R. 17, 18-19 (Bankr. S.D. Tex. 1991) (holding that liquidating dividends were to be considered proceeds of stock); *cf. supra* notes 41-45 and accompanying text (discussing depreciating collateral).

175. A dividend represents a decision by a company's directors to distribute certain assets to equity holders as opposed to using those assets for another purpose, such as corporate growth; and, to that extent, the dividend replaces that other use. However, the dividend should be compared to the stock value because it is the stock, and not the company's underlying assets, that is the collateral. There is, of course, some reduction in short term stock value as evidenced by the stock pages of newspapers which indicate

the liquidation value of the company issuing the dividend, investors value publicly traded stock less by the company's liquidation value and more by other factors exogenous to the company that signal a going concern, such as a multiple of corporate earnings.[176] The amount of the dividend is usually small enough relative to the stock price that these exogenous matters have more influence on investors than does the fact of the stock's trading ex-dividend.

Dividends on publicly traded stock therefore are non-replacement collateral because their value does not plainly correlate to the reduction in stock value. We then must go to the second step of the inquiry under the liquidation model and ask whether those dividends would be acquired by the debtor despite its liquidation. If the answer is yes, the dividends would be subject to the floating lien; if no, the dividends would be unencumbered.

How should one determine what collateral would be acquired by a debtor in a liquidation? The question sounds like conjuring but it is really quite straightforward. One simply asks, with regard to each item of non-replacement collateral that actually is acquired by the debtor during its bankruptcy case, whether that item would have been acquired by the debtor if it were in liquidation. This part of the Article deals with stock dividends. One need not try to figure out what dividends would arise during the debtor's bankruptcy. Rather, one merely looks to the dividends that *actually are paid to the debtor* during its reorganization in bankruptcy and asks whether those dividends would have been paid if the debtor were in a Chapter 7 liquidation[177] rather than a reorganization.[178] If they would have been paid, the dividends would be subject to the floating lien; if they would not have been paid, the dividends would be unencumbered.[179] In a

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whether the stock is trading ex-dividend. On the other hand, corporate finance theory maintains that a long-standing dividend policy is good for the price of stock. *See* Zohar Goshen, *Shareholder Dividend Options*, 104 YALE L.J. 881, 882, 885-86 (1995).

176. *See* WILBUR G. LEWELLEN, THE COST OF CAPITAL 88-93 (1969).

177. Of course, if the debtor actually liquidates in a Chapter 7 case, then *all* non-replacement collateral would be subject to the floating lien.

178. By the same token, one should not assume that the stock is sold in a liquidation and the dividends would not arise.

179. As an example of non-replacement collateral that would *not* arise in a liquidation, consider a lease that is entered into by a debtor during its bankruptcy reorganization; and assume that under non-bankruptcy law the floating lien covers leases but does not cover the underlying assets that are to be leased. If the reorganizing debtor enters into a new lease in connection with the ongoing operation of the business and that new lease would not have been needed if the debtor were liquidating, then the new lease would not be subject to the floating lien. Another example of non-liquidating collateral that, under the liquidation model, would not be subject to a floating lien is a factory that is subject to a floating lien under non-bankruptcy law but that the reorganizing debtor builds using un-

dispute, of course, the ultimate determination would be made by the court.

Ordinary dividends on publicly traded stock are paid at the discretion of the corporation *issuing* the stock. Payment is unrelated to the circumstances of the debtor that happens to own the stock; the estate of a liquidating debtor would be entitled to the same dividends as the estate of a debtor that continued in business. Therefore, under the second prong of the liquidation model, ordinary dividends on publicly traded stock would appear to be encumbered by the floating lien because such dividends would be acquired by the debtor despite its liquidation.

Questions can arise, however, as to how long the liquidating debtor would continue before ceasing to exist as an entity and what effect its non-existence would have on subsequent dividends? The answer to the first question would vary from case to case, and ultimately is a question of fact. Must the court hold a factual inquiry for each case? That would create a difficult burden for the judge. Furthermore, if the answer to the second question is that floating liens on subsequent dividends are cut off, that would be unfair to the secured creditor because, in an actual liquidation, the stock would be sold at or before the end of the case, and the secured creditor's lien (even under existing § 552(b)) would attach to the sale proceeds. If, therefore, the liquidation model were to cut off floating liens on subsequent dividends, it should allow the secured creditor to retain a lien on the stock to the extent of its then applicable sale value. Yet that would further complicate the inquiry because the judge now must determine not only the hypothetical liquidation period but also the collateral's value at the end of that period. To avoid these complications, we propose that the liquidation model be simplified by making the assumption, imperfect as it may be, that the debtor's liquidation period will exactly equal the period of the debtor's Chapter 11 reorganization case. That avoids the need to make any factual inquiry or valuation. Applying the liquidation model and this assumption to the stock hypothetical, all dividends arising during the debtor's reorganization would be encumbered by the floating lien.

2. Inventory

Under the liquidation model, as under existing § 552, handling most cases involving inventory is simple. Inventory is liquidating collateral. When the debtor sells inventory, it obtains cash or ac-

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encumbered funds.

counts receivable in return. The cash or accounts replaces and substitutes for the original collateral. The secured creditor therefore should have a security interest in the cash or accounts. The same result would be achieved under existing law.[180] This result would obtain even if, as is normally the case, the sale price of the inventory exceeds the inventory's cost to the debtor. Under the model, derivative assets that replace or substitute for pre-petition collateral are treated as if they constitute pre-petition collateral, and the secured party will be entitled to any appreciation in value.[181]

If the cash or accounts are subsequently used by the debtor to acquire new inventory, the new inventory would replace or substitute for such cash or accounts, and the secured party again will be entitled to any appreciation in value. This issue of whether a creditor can claim a security interest in second generation inventory is illustrated by *In re Bumper Sales, Inc.*[182] There, Marepcon loaned Bumper Sales $510,000 in order to expand its inventory of bumpers.[183] In return, Bumper Sales gave Marepcon a security interest in " 'all of . . . [its] inventory, accounts receivable, contract rights, furniture, fixtures and equipment, general intangibles, now owned or hereafter—acquired and the proceeds from said collateral.' "[184] Marepcon perfected by filing financing statements. When Bumper Sales filed for bankruptcy in August 1988, it owed Marepcon $499,964, and its inventory of bumpers was worth $769,000.[185] Marepcon consented to Bumper Sales' use of the proceeds of pre-petition inventory to finance the purchase of post-petition inventory.[186] On March 31, 1989, Marepcon stated a claim of $500,000 against Bumper Sales, asserted a security interest in its inventory, and sought adequate protection for this security interest.[187] The Unsecured Creditors Committee argued that § 552(a) cut off Marepcon's security interest in Bumper Sales' post-petition inventory and accounts.[188] Marepcon rebutted, stating that its security interest was valid because the post-petition inventory and accounts were "proceeds of Bumper Sales' pre-petition inventory and accounts [and noting] that Bumper Sales' post-petition inventory was

180. Indeed, the cash or accounts easily would qualify as proceeds under § 552(b).

181. *See supra* note 40 (citing Dewsnup v. Timm, 502 U.S. 410 (1992)).

182. 907 F.2d 1430 (4th Cir. 1990).

183. *See id.* at 1432.

184. *Id.*

185. *See id.*

186. *See id.*

187. *See id.* at 1433.

188. *See id.* at 1436.

financed solely by the proceeds of its pre-petition inventory and accounts."[189]

The court held that Bumper Sales' post-petition inventory and accounts constituted proceeds within the meaning of § 552(b).[190] Quoting Professor Barkley Clark, the *Bumper Sales* court reasoned that drawing a bright line " 'between first-generation proceeds and after-acquired property... could completely deprive the secured party of his pre-petition perfected security interest.' "[191] Although Marepcon was able to claim second generation proceeds only because Bumper Sales used the first generation proceeds, the *Bumper Sales* court reached a result that is consistent with the model.[192] The new inventory was replacement collateral for the original inventory. Marepcon's security interest in the pre-petition inventory therefore should extend to the after-acquired inventory.

In applying the liquidation model to inventory, there is a semantic confusion that can arise in interpreting the phrase "replace or substitute for." It does not mean generic categories of collateral, such as "inventory," but rather specific items of collateral, such as the underlying goods. Thus, in the discussion in Part II.A, although the diamond tennis bracelets constituted inventory that, in a broad sense, replaced and substituted for the pre-petition inventory of plastic rings, the bracelets did not replace or substitute for the rings for purposes of the liquidation model. The model is applied by looking solely to the underlying property rights.[193]

Another issue arises where the inventory is not sold but leased post-petition.[194] Do the lease payments replace or substitute for the

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189. *Id.*

190. *See id.* at 1439.

191. *Id.* (quoting CLARK, *supra* note 48, at ¶ 6.6[3]).

192. Marepcon should have petitioned the court to order Bumper Sales to give it adequate protection in the form of second generation proceeds for the use of the first generation proceeds. *See* 11 U.S.C. § 363(e) (1994); *see also id.* § 361 (defining adequate protection); *supra* notes 100-35 and accompanying text (discussing fairness evaluations of the liquidation model).

193. Professor Lynn LoPucki suggested to the author a second example: The debtor owns a beat-up 1985 Chevy van worth $5,000 which it uses for making deliveries. After filing bankruptcy, the debtor sells that van and purchases a new Chevy van for $20,000 which it uses for the same purpose. The money for the new van comes from general revenues of the business. In common usage, the new van "replaces" the old one and "substitutes" for it. But to allow the secured creditor to have the new van as collateral is unfair to the unsecured creditors. The liquidation model would not permit that result because the underlying property rights in the new van, except perhaps to the extent of the $5,000 received for the old van if used as part of the new van's purchase price, substitute only for the general revenues of the business.

194. *See* U.C.C. § 9-109(4) (1995) (providing that goods are inventory under the UCC

inventory?[195] A lease is merely a sale of a portion of the inventory, with the lessor having the right to take back the unsold portion (called the residual value) at the end of the lease term.[196] Lease payments are the equivalent of the purchase price of, and therefore substitute for, the portion of the inventory sold; they therefore would be subject to the floating lien. The lien also continues in the inventory returned at the end of the lease term, because it is pre-petition collateral.[197]

3. Contract Rights

When creditors are secured by rights in pre-petition contracts,[198] courts usually have extended the security interests to the payments and other after-acquired collateral that the contracts generate in bankruptcy.[199] However, they have given very little explanation for

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"if they are held by a person who holds them for sale or lease").

195. *Compare infra* notes 220-23 and accompanying text (discussing equipment leases), *with infra* notes 224-29 and accompanying text (discussing hotel revenues).

196. For a discussion of the right to sell portions of an asset, see U.C.C. § 2-105(3), (4) (1995) (permitting sales of part interests in goods and undivided interests in fungible goods); Steven L. Schwarcz, *The Parts Are Greater Than the Whole: How Securitization of Divisible Interests Can Revolutionize Structured Finance and Open the Capital Markets to Middle-Market Companies*, 1993 COLUM. BUS. L. REV. 139, 149-51 [hereinafter Schwarcz, *Divisible Interests*] (discussing sales of portions of intangible assets).

197. Even if the cumulative post-petition rent payments and residual value exceed the amount that the inventory could have been sold for outright, the floating lien should continue. A secured party is entitled to market appreciation of collateral, and choosing to lease rather than sell the inventory is simply a strategy to maximize its value. *See* Dewsnup v. Timm, 502 U.S. 410, 417 (1992).

198. Whether or not security interests in contract proceeds will survive bankruptcy, the fact that the debtor may, subject to restrictions, choose to reject executory contracts that are not advantageous to the bankruptcy estate can place certain limitations on the value of these contracts in bankruptcy. *See* 11 U.S.C. § 365 (1994); *see also* J. Catton Farms, Inc. v. First Nat'l Bank of Chicago, 779 F.2d 1242, 1247 (7th Cir. 1985) ("It is true that the bankruptcy judge can ... allow a debtor to disaffirm an executory contract .... But that was not done here. The bank was lucky that it was not done."). It is assumed that certain contracts will not be disaffirmed because the debtor expects they will have value even after the secured party's debt is paid in full.

199. For a case allowing perfected security interests in the proceeds of contracts and agreements not mentioned in the text of this Article, see *Carlson v. W.J. Menefee Constr. Corp. (In re Grassridge Indus.)*, 78 B.R. 978, 981 (Bankr. W.D. Miss. 1987) (holding that a creditor's security interest in the proceeds of a construction contract survived the filing of the bankruptcy petition); *see also J. Catton Farms*, 779 F.2d at 1247 (holding that bank had a security interest in proceeds of a PIK contract under which the Department of Agriculture paid farm not to grow corn).

Bankruptcy courts have allowed creditors with security interests in contracts to claim the proceeds of oral agreements. *See* James Cable Partners L.P. v. Citibank (*In re* James Cable Partners, L.P.), 141 B.R. 772, 776-77 (Bankr. M.D. Ga. 1992) (allowing creditor that had a security interest in debtor's contract rights to claim the post-petition proceeds of oral cable subscription agreements that existed pre-petition); Nanuet Nat'l Bank v.

their decisions. Because a long term licensing agreement is very different from a contract to make a single shipment of goods, there is no assurance that future decisions will be uniform. The courts therefore need to articulate a test that applies to all types of contracts.

Before attempting to articulate a test, it is useful to examine some representative cases. In *J. Catton Farms, Inc. v. First National Bank of Chicago*,[200] a bank loaned J. Catton Farms, a large farming operation, $6 million secured by the operation's " 'receivables, accounts, inventory, equipment and fixtures and the proceeds and products thereof.' "[201] The loan agreement specified that "receivables" included " 'all accounts, contract rights including, without limitation, all rights under installment sales contracts[,] ... and general intangibles ... in which the debtor has or hereafter acquires any right.' "[202] The farming operation signed a payment-in-kind ("PIK") contract[203] with the Department of Agriculture in March 1983. The contract provided that if J. Catton Farms refrained from planting certain crops during the growing season, the federal government would pay it the value of the unplanted crops. In April 1983, J. Catton Farms filed a petition under Chapter 11 of the Code. Having refrained from planting the crops specified in the PIK contract, it became entitled to receive the value of the unplanted crops from the Department of Agriculture in June 1983. The bank claimed that it had a security interest in the proceeds of the PIK contract. The court held that a security interest in the proceeds of contracts made before bankruptcy can survive bankruptcy.[204] It reasoned that "liens in proceeds ... are said to pass through bankruptcy unaffected."[205]

Another leading § 552 contract case is *United Virginia Bank v.*

Photo Promotional Assocs. (*In re* Photo Promotion Assocs.), 61 B.R. 936, 939 (Bankr. S.D.N.Y. 1986) (holding that security interest in debtor's contracts extended to the proceeds of pre-petition oral agreements to process film).

200. 779 F.2d 1242 (7th Cir. 1985).

201. *Id.* at 1244 (quoting loan agreement).

202. *Id.* (quoting loan agreement).

203. For cases and commentary dealing with the proceeds of PIK contracts, see *In re Schmaling*, 783 F.2d 680, 682-83 (7th Cir. 1986) (holding that security interest in "corn and all other crops grown or growing" did not extend to proceeds of a PIK contract); *In re Sunberg*, 729 F.2d 561, 562 (8th Cir. 1984) (holding that pre-petition security agreement in contract rights extended to proceeds of PIK contract under § 552(b)); *see also* Kunkel, *supra* note 153, at 330-32; Paul B. Rasor & James B. Wadley, *The Secured Farm Creditor's Interest in Federal Price Supports: Policies and Priorities*, 73 KY. L.J. 595, 651-57 (1985).

204. *See J. Catton Farms*, 779 F.2d at 1247.

205. *Id.* Enforcement would be subject, of course, to the automatic stay under 11 U.S.C. § 362.

Slab Fork Coal Co.[206] Slab Fork contracted to sell coal to Armco at a price advantageous to Slab Fork. After Slab Fork filed its bankruptcy petition, it shut down mining operations but, to preserve its profitable coal supply agreement, it contracted to purchase coal from Maben Coal Company for resale to Armco. United Virginia Bank, one of Slab Fork's creditors, had a pre-petition security interest in Slab Fork's contracts, including the coal supply contract with Armco. Slab Fork claimed that § 552(a) cut off United Virginia Bank's interest in the contract proceeds.[207] In response, United Virginia Bank filed a motion to prohibit Slab Fork's use of the contract proceeds minus the payment of Maben Coal's expenses.[208] The court held that under § 552(b) the post-petition contract proceeds were subject to the pre-petition security interest.[209] It reasoned that "[n]o change in the right to payment under the Armco contract was brought about by the filing of a bankruptcy petition, where the underlying asset and all proceeds therefrom were subject to a valid pre-petition security interest."[210] Certainly, "[i]t is true that coal had to be supplied to Armco by or for Slab Fork before any right to payment arose, but that is true for all the payments under the contract, whether generated pre-petition or post-petition."[211]

Although the outcomes of these cases will be shown to be consistent with the liquidation model, the courts need to articulate a rationale. *This is particularly important when structuring commercial and financial transactions*[212] because investors in those transactions often depend on future-arising financial assets, such as rights coming due under contracts, to generate cash for repayment.[213] If there is uncertainty whether the investors will be entitled to those rights, the transactions may not be viable.[214] Under the liquidation model, a court should first ask whether the new, post-petition assets replace or substitute for a portion of the contracts. In *Slab Fork Coal* and *J. Catton Farms*, the contracts at issue were clearly liquidating collateral. Each contract represented a finite bundle of rights. When each

206. 784 F.2d 1188 (4th Cir. 1986); *see also* Tarkenton, *supra* note 153, *passim* (discussing *Slab Fork Coal*).
207. *See Slab Fork Coal*, 784 F.2d at 1189.
208. *See id.*
209. *See id.* at 1190.
210. *Id.* at 1191.
211. *Id.*
212. *See supra* note 5.
213. *See* Schwarcz, *Alchemy*, *supra* note 25, at 135-36.
214. *See id.*

of the contracting parties performed part of the agreement, each earned a right to payment. The receipt of payment extinguished that right so the value of the contract decreased as it generated payments. Because the payments replaced, or substituted for, a portion of the contracts, they should be subject to the pre-petition security interest.

In contrast to the contracts at issue in *Slab Fork Coal* and *J. Catton Farms*, some contracts may confer indefinite rights. Suppose HiTech developed a special metal finishing process that prevents rust. It grants Steel Mill a license to use the process so long as Steel Mill pays an agreed royalty. If HiTech files a bankruptcy petition, should a floating lien on the licensing agreement extend to the ongoing royalty payments? Under the model, a court should first ask whether Steel Mill's royalty payments replace or substitute for a portion of the licensing agreement. The answer is not immediately obvious because one cannot *ex ante* quantify the amounts. One might argue that the royalty payments do not replace or substitute for the licensing agreement. The fallacy of such an argument, however, is its incorrect assumption that rights must be quantified in advance. Even if one cannot quantify in advance the aggregate amount of royalty payments that will be made over the life of the contract, so long as that amount is finite[215] each payment made will reduce, *pro tanto*, the aggregate.[216] Seen from this perspective, the individual royalty payments plainly substitute for a portion of the contract, and therefore should be subject to the floating lien.

Can a model based on Chapter 7 assume that a liquidating debtor will continue to perform the contract in order to generate payments thereunder? The answer is that a debtor may continue in limited operation, even in a Chapter 7 liquidation, in order to preserve the value of an asset of the estate. The assumption that a debtor may continue performing a valuable contract in order to maximize the estate is therefore not inconsistent with a liquidation

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215. However, pre-petition collateral that generates a stream of payments with no definable duration would be non-liquidating collateral if the value of the payments does not plainly correlate to the reduction in collateral value. *See supra* text accompanying notes 41-45. The payments therefore would be non-replacement collateral. *See supra* notes 75-92 and accompanying text. A possible example of this type of collateral is the public stock of a blue-chip company, expected to continuously generate dividends. *See supra* notes 160-79 and accompanying text.

216. It is, of course, a bit of an oversimplification to say that payment of one of a series of payments reduces *pro tanto* the aggregate. Each payment might be seen as reinforcing the market value of the remaining payments by reinforcing expectations; that does not, however, change the essential conclusion of the text.

model.[217] This Article will show, however, that the debtor's cost of continued performance should be subtracted from the payments generated post-petition under the contract.[218]

The foregoing discussion of contracts focused on floating liens on a debtor's pre-petition contracts. But what if the contract in question is entered into post-petition? The inquiry then would be whether that contract replaced or substituted, and therefore was replacement collateral, for other pre-petition collateral, or whether it would be generated in the debtor's liquidation. A typical illustration of that issue arises in post-petition leases of pre-petition collateral.[219]

4. Equipment Leases and Equipment

Equipment leases are merely a specialized form of contract. Most of the current case law construing the interaction of § 552 and equipment leases is straightforward. Courts have consistently held that a creditor's security interest in pre-petition leases extends to all post-petition rentals paid under these leases.[220] The liquidation model would reach the same result. Lease contracts represent a finite bundle of rights and therefore constitute liquidating collateral. As each rental payment is received, the value of the lease diminishes. Thus, bankruptcy courts should extend pre-petition security interests in leases to the post-petition rentals.

A more interesting question arises, however, when the floating lien covers pre-petition equipment that is leased post-petition. Is the post-petition lease subject to the floating lien? Under existing law, rentals of pre-petition property are covered by a floating lien.[221] Un-

217. As discussed *supra* at text accompanying note 78, 11 U.S.C. § 721 (1994) permits such limited operation. Technically, however, § 721 refers to the operation of the business "for a limited period." This suggests a possible limitation on the model. In some contracts the amount of future payments expected may be so large compared to the debt secured by the floating lien that allowing the lien to encumber all such payments would violate the so called "smell test." In those cases, a court may well cut off the floating lien on payments that are clearly unnecessary to repay the debt. *Cf.* EPSTEIN ET AL., *supra* note 1, § 3-27 (discussing the amount of the equity cushion that a secured creditor is entitled to as adequate protection of its lien); Schwarcz, *Divisible Interests*, *supra* note 196, at 155 n.45 (suggesting that, irrespective of theory, a purchase price may be so low compared to the amount of the payment stream to which the buyer can look for repayment that the transaction would violate the "smell test" and be considered a secured loan rather than a true sale).

218. This provides a conceptual underpinning for the "equities" exception in § 552(b). *See infra* notes 249-85 and accompanying text.

219. *See infra* notes 220-23 and accompanying text.

220. *See, e.g.,* Lease-A-Fleet, Inc. v. University Cadillac, Inc. (*In re* Lease-A-Fleet, Inc.), 152 B.R. 431, 436-37 (Bankr. E.D. Pa. 1993).

221. *See* 11 U.S.C. § 552(b)(2).

der the model, one first must ask whether the lease replaces or substitutes for the equipment. That question already has been addressed in analyzing post-petition leases of inventory.[222] A lease of an asset is merely the sale of a portion of the asset, with the lessor having the right to take back the unsold portion (the residual value) at the end of the lease term.[223] Because rent payments are replacement collateral for the portion of the equipment sold, rentals also would be subject to the floating lien under the model.

5. Hotel Revenues

Congress recently amended the § 552(b) exception to include security interests in hotel revenues.[224] Specifically, the amendment states that security interests in "rents of [pre-petition property], . . .

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222. *See supra* notes 180-97 and accompanying text.

223. *See id.* This analysis is equally applicable to licenses or any other third party use of a tangible asset for pay.

224. Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, § 214, 108 Stat. 4106, 4126. For comprehensive articles describing the case law before the enactment of the Bankruptcy Reform Act of 1994, see Averch, *supra* note 153, at 486-87 (arguing that bankruptcy courts should treat hotels differently from other income-producing real property and that hotel revenues are proceeds within the meaning of § 552(b)); Freyermuth, *supra* note 153, at 1465-66 (arguing that monies paid by commercial occupants are proceeds of the commercial real estate development and should be protected in bankruptcy under § 552(b)). Before Congress mooted the debate, the weight of authority followed the Ninth Circuit case *Greyhound Real Estate Finance Co. v. Official Unsecured Creditors Comm. (In re Northview Corp.)*, 130 B.R. 543, 547 (B.A.P. 9th Cir. 1991) (holding that hotel revenues are newly created accounts, rather than proceeds, under Article 9). *See also* Casco N. Bank v. Green Corp. (*In re* Green Corp.), 154 B.R. 819, 825 (Bankr. D. Me. 1993) (holding that income from room rental was not "rents," "profits" or "proceeds" under the Bankruptcy Code); *In re* General Assoc. Investors Ltd. Partnership, 150 B.R. 756, 762 (Bankr. D. Ariz. 1993) (same); *In re* Corpus Christi Hotel Partners, 133 B.R. 850, 854-55 (Bankr. S.D. Tex. 1991) (holding that hotel revenues are neither profits nor proceeds within the meaning of the Bankruptcy Code and the U.C.C.); *In re* Shore Haven Motor Inn, Inc., 124 B.R. 617, 618 (Bankr. S.D. Fla. 1991) (holding that revenues from the operation of a hotel are personalty, not rent); *In re* Majestic Motel Assocs., 131 B.R. 523, 526 (Bankr. D. Me. 1991) (holding that since hotel revenues are derived largely from labor and services, they are not rents or profits derived from real property); Kearney Hotel Partners v. Richardson (*In re* Kearney Hotel Partners), 92 B.R. 95, 103-04 (Bankr. S.D.N.Y. 1988) (holding that security interest in revenues from hotel operations is a security interest in personalty, not realty); *In re* Ashkenazy Enters., Inc., 94 B.R. 645, 646-47 (Bankr. C.D. Cal. 1986) (holding that a creditor's lien on hotel's operating revenues was not a lien in rent). Under this reasoning, § 552(a) cuts off security interests in hotel revenues. However, some cases held that hotel revenues constituted proceeds, profits, products, rents or offspring within the meaning of § 552(b). *See* S.F. Drake Hotel Assocs. v. Security Pac. Nat'l Bank (*In re* S.F. Drake Hotel Assocs.), 147 B.R. 538, 539 (N.D. Cal. 1992). Specifically, courts found that hotel receipts were profits, see *Mid City Hotel Assocs. v. Prudential Ins. Co. of Am. (In re Mid-City Hotel Assocs.)*, 114 B.R. 634, 641-42 (Bankr. D. Minn. 1990), or rents, see *T-H New Orleans Ltd. Partnership v. Financial Sec. Assurance, Inc.*, 10 F.3d 1099, 1105 (5th Cir. 1993).

or the fees, charges, accounts, or other payments for the use or occupancy of rooms and other public facilities in hotels, motels, or other lodging properties" continue in bankruptcy.[225] The amendment, however, may have gone too far in subjecting post-petition assets to a pre-petition security interest.

Under the liquidation model, the first inquiry is whether the post-petition rents or other payments replace or substitute for the pre-petition collateral. When creditors take a floating lien only on hotel room rentals, the post-petition rents do not substitute for the pre-petition rents. The pre-petition rents generate cash proceeds in the form of rental payments. And the cash, not the future rentals, substitutes for the pre-petition rentals.[226] But if a creditor is secured pre-petition by the hotel building, and not merely by its rentals, the floating lien should extend to rental payments made after the debtor files the bankruptcy petition.[227] The analysis would be the same as for post-petition rentals of inventory or equipment.[228] Just as with rentals of inventory or equipment, the lease of a hotel room can be viewed as a sale of a portion of the hotel, limited in the case of a hotel not only by time (the occupancy period) but also by space (the room). The lease payment is the equivalent of the purchase price of, and therefore replaces, the portion of the hotel room sold, and therefore would be subject to the floating lien.

The amended § 552, however, is ambiguous as to whether it would extend floating liens on hotel room rentals to post-petition rentals regardless of whether the creditor is secured by the hotel building or merely by the rentals. It is unclear from the statutory language whether the phrase "fees, charges, accounts, or other payments for the use or occupancy of rooms . . . in hotels . . . ," in which a post-petition security interest is specifically recognized, modifies the pre-petition security interest or only modifies the pre-petition property already subject to a security interest. If courts uphold an interpretation that a pre-petition security interest in payments for the

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225. *See* Bankruptcy Reform Act of 1994, § 214, 108 Stat. at 4126.

226. The same argument would apply to a security interest in accounts receivable, which applies to all accounts in existence as of the date of bankruptcy and to subsequently received proceeds of such accounts. Such a pre-petition security interest would not, however, apply to accounts merely generated by the sale of goods or provision of services by the bankrupt debtor.

227. Although allowing parties to use contractual terms to obtain different substantive rights in bankruptcy may appear somewhat arbitrary, it is no different than the basic concept of recognizing contractually agreed to security interests in bankruptcy. Third parties are not misled, because financing statements notify them of the arrangement.

228. *See supra* notes 180-97, 220-23 and accompanying text.

use or occupancy of hotel rooms continues post-petition, then § 552(b) would be inconsistent both with existing law and the liquidation model. For example, if a creditor makes a loan to a cruise line and encumbers its existing and future cabin revenues, the floating lien would not encumber post-petition cabin rentals. Courts are likely to find that the security interest in the cabin revenues is merely a floating lien[229] on the cruise line's accounts and use § 552(a) to cut off the lien.

6. "All Assets" of a Business

Particularly in loans to small or medium size businesses, a secured creditor's floating lien may cover *all* of the debtor's existing and future assets. The language of § 552(b) suggests that all of the debtor's post-petition assets would then be encumbered because such assets are "proceeds, product, offspring or profits" of the pre-petition business.[230] That result, however, would deprive debtors of any real opportunity for a fresh start.[231] Using the liquidation model to analyze this problem, one first would ask whether the debtor's post-petition assets replace or substitute for the pre-petition business. This, however, is a tricky question for an ongoing business. A "going concern" business represents more than just the sum of its assets.[232]

229. No pun intended!

230. Section 552(b) states that a pre-petition security interest extends to post-petition "proceeds, product, offspring or profits" of "property of the debtor acquired before the commencement of the [bankruptcy] case." 11 U.S.C. § 552(b) (1994). There is, however, uncertainty under present law whether only the first generation of derivative assets should be protected under § 552(b). *See, e.g.*, EPSTEIN ET AL., *supra* note 1, § 6-78, at 416:

> Suppose that a bank has a perfected security interest in the debtor's crops and all receivables and intangibles of the debtor, present and after acquired. The debtor files bankruptcy in 1990 after having planted that year's crop. Under local law and § 552(b), the bank's security interest will extend to any and all proceeds of the 1990 crop.... It does not matter that the proceeds are paid post-petition or even that the contracts or other arrangements for acquiring the proceeds were made post-petition.... The bank's security interest will not extend to the debtor's 1991 crop or any of its proceeds unless § 552(b) protects mediate proceeds and the bank can make the necessary, difficult proof.

For a discussion of second generation proceeds of inventory, see *supra* text accompanying notes 180-97.

231. In theory, if the value of a debtor's pre- and post-petition assets significantly exceeds the amount of secured debt, the debtor might obtain partial relief from the floating lien. *See supra* notes 108-13 and accompanying text. The "equities" exception in § 552(b) also could give the debtor a chance to limit the floating lien, although its use would create significant uncertainty in the law. *See infra* notes 249-85 and accompanying text.

232. *See, e.g.*, Douglas G. Baird & Thomas H. Jackson, *Bargaining After the Fall and the Contours of the Absolute Priority Rule*, 55 U. CHI. L. REV. 738, 782-87 (1988) (arguing that management of a debtor creates the extra value of a "going concern" above the value

Therefore, the "asset" represented by the ongoing business is not necessarily the same as the sum of the debtor's individual assets.[233] Because the model is based on a liquidation and not a going concern theory, the appropriate application of the model would be to view the debtor as merely an aggregate of individual liquidating assets.

One therefore should apply the "replacement or substitution" test of the model by inquiring with respect to each item of pre-petition collateral whether that item is liquidating collateral. Post-petition assets that replace or substitute for liquidating collateral would be replacement collateral and therefore subject to the floating lien according to the methodology previously applied under the model to various types of collateral.[234] On the other hand, to the extent post-petition assets are non-replacement collateral, the inquiry under the model turns to whether those assets would be acquired despite the debtor's liquidation. Again, that would be an item by item inquiry using the methodology previously developed under the model for different asset categories.[235]

In summary, because the "asset" represented by a going concern business is fundamentally different than the sum of the individual assets used in the business, and the model is based on a liquidation theory, one would apply the model to the debtor's *individual* assets according to the methodology previously developed in this Article. That preserves the balance between creditors' rights and debtor rehabilitation.

7. True Sales

A true sale is a sale of accounts or other intangibles that legally separates the future payment stream from the estate of the selling company.[236] True sales are growing in importance as the central element of a type of financing variously known as structured finance or

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of the debtor's specific assets); *cf.* David Gray Carlson, *Secured Creditors and the Eely Character of Bankruptcy Valuations,* 41 AM. U. L. REV. 63, 88-89 (1991) (arguing that Baird and Jackson's argument "may suffice when management is not fungible, but it fails if management is easily replaced").

233. *Cf. supra* notes 160-79 and accompanying text (discussing stock dividends).

234. *See supra* notes 160-229 and accompanying text. Single asset real estate bankruptcies are functionally unique because there is only one asset, and therefore the liquidation model should be applied to that asset as a single item of pre-petition collateral.

235. *See supra* notes 160-229 and accompanying text.

236. This legal separation is important because it means that the buyer owns the accounts even if the seller later files for bankruptcy. *See* Steven L. Schwarcz, *"Octagon Gas" Ruling Creates Turmoil for Commercial and Asset-Based Finance,* N.Y.L.J., Aug. 4, 1993, at 1.

asset securitization.[237] In a structured financing, the selling company (the originator) generally transfers its right, title, and interest in the payment stream to a special purpose vehicle ("SPV").[238] The SPV issues capital market securities whose proceeds are used to purchase the payment stream, and investors buy the securities based on their assessment of the value of the payment stream.

Does § 552 cut off a pre-petition sale of the right to post-petition payments? Although bankruptcy courts have not yet addressed the question of whether § 552 applies to true sales, the language of the statute suggests that it does not. Section 552 governs only security agreements, which the Code defines as an "agreement that creates or provides for a security interest."[239] According to the Code, a security interest is a "lien created by a [security] agreement."[240] Thus, on its face, § 552 cuts off floating liens but does not cut off ongoing sales.

Some might argue, nonetheless, that § 552 cuts off pre-petition sales of future receivables that arise post-petition because, under the UCC, a security interest "includes any interest of a *buyer* of accounts or chattel paper which is subject to Article 9."[241] Article 9 applies "to any sale of accounts or chattel paper."[242] The UCC official uniform commentary explains that "sales of accounts ... are brought within this Article to avoid difficult problems of distinguishing between transactions intended for security and those not so intended"[243] because "[c]ommercial financing on the basis of accounts ... is often so conducted that the distinction between a security transfer and a sale is blurred."[244] However, this argument would be fallacious for the same reason that the Tenth Circuit's decision in the much criticized

237. *See, e.g.*, Schwarcz, *Alchemy*, *supra* note 25, at 141; Schwarcz, *Divisible Interests*, *supra* note 196, at 143-45.

Structured finance, which is sometimes called securitization, is "becoming one of the dominant means of capital formation in the United States." Investment Company Act Release No. 19,105, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,062, at 83,500 (Nov. 19, 1992) (provided in connection with the issuance of Rule 3a-7 under the Investment Company Act of 1940). It is expected to continue to grow in importance as a source of capital. *See, e.g.*, *You Can Securitize Virtually Everything*, BUS. WK., July 20, 1992, at 78. For an introduction to the subject of structured finance, see generally STEVEN L. SCHWARCZ, STRUCTURED FINANCE: A GUIDE TO THE PRINCIPLES OF ASSET SECURITIZATION (2d ed. 1993).

238. *See* Schwarcz, *Divisible Interests*, *supra* note 196, at 143-44.

239. 11 U.S.C. § 101(50) (1994).

240. *Id.* § 101(51).

241. U.C.C. § 1-201(37) (1995) (emphasis added).

242. *Id.* § 9-102(1)(b).

243. *Id.* § 9-102 cmt.

244. *Id.* cmt. 2.

case of *Octagon Gas Systems, Inc. v. Rimmer*[245] was fallacious: the inclusion of the sale of accounts within Article 9 is solely for purposes of perfection and priority, and should not address substantive rights in bankruptcy.[246] Furthermore, the point of a true sale is to have a transaction in which there is a recognizable distinction between a security transfer and a sale. Section 552 therefore should not cover true sales. Nonetheless, property generated by the debtor post-petition is theoretically property of the debtor's estate for an instant. Thus, § 362,[247] the Code's automatic stay provision, may condition its ongoing sale on judicial lifting of the stay.[248]

8. Milk from a Cow

The reader may finally ask, so what about milk from a cow—does the liquidation model solve that riddle? Well, it does. The milk does not replace or substitute for the cow because the value of milk produced in any given period would not plainly correlate to the reduction in the cow's value during that period. Nonetheless, a court is likely to conclude that a debtor owning a cow would continue, even in liquidation, to milk the cow pending its sale, and therefore the milk is an asset that would arise in the debtor's Chapter 7 liquidation. Accordingly, under the liquidation model, the milk would appear to be subject to the floating lien.

C. Equities Exception

The equities exception in § 552(b) compounds the uncertainty of § 552 interpretation.[249] This exception, read literally, appears to give

245. 995 F.2d 948, 954-55 (10th Cir. 1993) (stating that accounts cannot be sold because the UCC treats their transfer as a security interest for perfection and priority purposes).

246. *See* PERMANENT EDITORIAL BOARD FOR THE UNIFORM COMMERCIAL CODE, COMMENTARY NO. 14 (1994).

247. *See* 11 U.S.C. § 362 (1994).

248. The discussion *supra* notes 236-47 and accompanying text assumes, of course, that the sale of future assets is valid under applicable state law. It should be cautioned that the common law governing the sale of intangibles is ambiguous as to the effectiveness of the sale of an intangible asset that does not exist on the date of its purported sale. *Compare* New York Sec. & Trust Co. v. Saratoga Gas & Elec. Light Co., 53 N.E. 758, 760 (N.Y. 1899) (holding that purchaser of accounts must ensure that the subject matter of accounts involves a right existing at the time of assignment in order to protect its interest from general creditors), *with* Rockmore v. Lehman, 128 F.2d 564 (2d Cir.), *rev'd on reh'g*, 129 F.2d 892, 893 (2d Cir. 1942) (holding that assignment of account which arose from contract already in existence was a legal assignment with priority over prior or subsequent equitable claims and over subsequent lien creditors in a court of law). *Accord* Schwarcz, *Divisible Interests, supra* note 196, at 149 n.36.

249. *See* 11 U.S.C. § 552(b) (1994). For a general discussion of the equities exception,

bankruptcy courts broad discretion to invalidate security interests that otherwise survive the filing of the bankruptcy petition. According to the statute, a security interest that properly extends to "proceeds, product, offspring or profits" within the meaning of § 552(b) is valid in bankruptcy "*except* to any extent that the court, after notice and a hearing and based on the equities of the case, orders otherwise."[250] The liquidation model of this Article, however, significantly reduces the need for an equities exception under § 552(b). Because the post-petition application of the floating lien is more focused under the model, there is less room for judicial discretion. Nonetheless, the debtor may incur costs even in liquidation in order to generate post-petition collateral. These costs include collecting and reducing to money the property of the estate, and operating the business of the debtor for a limited period, in each case in order to maximize collateral and estate value.[251] The following discussion addresses how the debtor should be compensated for these costs. *The discussion also serves as an analysis of the existing equities exception under § 552(b), whether or not the liquidation model is adopted.*

The legislative history suggests that the purpose of the equities exception is actually very limited. Congress seems to have intended it to cover situations where the "estate acquires the proceeds to the prejudice of other creditors holding unsecured claims."[252] The legislative history explains that "[t]he exception is to cover the situation where raw materials, for example, are converted into inventory, or inventory into accounts, at some expense to the estate, thus depleting the fund available for general unsecured creditors."[253] The problem, however, is that if Congress wanted so to limit the equities exception,

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see Nancy L. Sanborn, Note, *Avoidance Recoveries in Bankruptcy: For the Benefit of the Estate or the Secured Creditor?*, 90 COLUM. L. REV. 1376, 1390-92 (1990).

250. 11 U.S.C. § 552(b) (emphasis added).

251. *See supra* text accompanying notes 121-22.

252. H.R. REP. NO. 95-595, at 377 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6333; *see also* S. REP. NO. 95-989, at 91 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5877 (using substantially the same language as the House Report).

253. H.R. REP. NO. 95-595, at 377 (1977), *reprinted in* 1978 U.S.C.C.A.N. at 6333; *see also* S. REP. NO. 95-989, at 91 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5877 (using substantially the same language as the House Report); *see also* 124 CONG. REC. 34,000 (1978) (statement of Sen. DeConcini) ("[T]he provision allows the court to consider the equities in each case. In the course of such consideration the court may evaluate any expenditures by the estate relating to proceeds and any related improvement in position of the secured party."); *id.* at 32,400 (1978) (statement of Rep. Edwards) (making similar statement); S. REP. NO. 95-989, at 91 (1977), *reprinted in* 1978 U.S.C.C.A.N. at 5877 (stating that the exception may be used when expenditures to acquire the proceeds "resulted in an improvement in the position of the secured party").

why didn't it explicitly state the limitation in the statute?

1. Current Case Law

Given the disparity between the broad statutory language and the more narrow legislative history, it is not surprising that courts construing the equities exception have rendered widely varying interpretations.[254] A number of bankruptcy courts, following an ambiguous dictum in the Fourth Circuit's opinion in *United Virginia Bank v. Slab Fork Coal Co.*,[255] have suggested that the equities exception may be used to invalidate security interests that would otherwise be valid under § 552(b), simply in order to promote the debtor's fresh start:

> As evidenced by the final clause in § 552(b), a bankruptcy court may choose not to apply a pre-petition security interest to post-petition proceeds "based on the equities of the case." It appears clear from the legislative history related to § 552 that Congress undertook in that section to find an appropriate balance between the rights of secured creditors and the rehabilitative purposes of the Bankruptcy Code. The latitude afforded to the bankruptcy court seems to this court to indicate that such a balancing of interests was intended in the framing of § 552.[256]

Other courts, however, have limited the equities exception to "expenditures of time, labor, and funds relating to the collateral ... and the overall rehabilitative theme of bankruptcy law."[257] These courts have considered whether recognizing the secured creditor's interest in proceeds, profits, products, or offspring would constitute an improvement in the creditor's overall position.[258] If, for example the secured creditor is "oversecured," then these courts might invoke the equities exception to reduce the collateral cushion in order to facilitate the debtor's fresh start.

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254. Even the very same court has rendered diametrically opposed characterizations of the equities exception. *Compare In re* Lawrence, 41 B.R. 36, 37 (Bankr. D. Minn. 1984) ("The general rule of Section 552(a) is subject to a *very narrow* exception described in Section 552(b).") (emphasis added), *with In re* Jackels, 55 B.R. 67, 68 (Bankr. D. Minn. 1985) ("While § 552(a) essentially terminates security interests as a general rule, there is a *very large* exception found in § 552(b).") (emphasis added).

255. 784 F.2d 1188 (4th Cir. 1986).

256. *Id.* at 1191. The author is not, however, aware of any case that imposes such a draconian result.

257. *Lawrence*, 41 B.R. at 38; *see also In re* Vanas, 50 B.R. 988, 997 (Bankr. E.D. Mich. 1985) (approving *Lawrence*); *In re* Serbus, 48 B.R. 5, 8 (Bankr. D. Minn. 1984) (same).

258. *See Vanas*, 50 B.R. at 997; *Lawrence*, 41 B.R. at 38.

Several courts have held that the equities exception should only be invoked in cases where the trustee or debtor-in-possession has used assets from the bankruptcy estate to create post-petition collateral to the detriment of unsecured creditors.[259] Judge Posner, writing for the Seventh Circuit, explained this approach to the equities exception:

> Suppose a creditor had a security interest in raw materials worth $1 million, and the debtor invested $100,000 to turn those raw materials into a finished product which he then sold for $1.5 million. The proceeds of this sale (after deducting wages and other administrative expenses) would be added to the secured creditor's collateral unless the court decided that it would be inequitable to do so—as well it might be, since the general creditors were in effect responsible for much or all of the increase in the value of the proceeds over the original collateral.[260]

The Fifth Circuit's gloss on the equities exception holds that unless a secured creditor has increased its collateral to the detriment of unsecured creditors, the debtor-in-possession may not seek relief under the equities exception and, instead, if it wishes to use the collateral, must petition for permission under § 363 of the Code.[261] Most debtors-in-possession would like to avoid this route because § 363 requires that they provide adequate protection against loss before they use the collateral.[262]

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259. *See, e.g.*, J. Catton Farms, Inc. v. First Nat'l Bank of Chicago, 779 F.2d 1242, 1246-47 (7th Cir. 1985); Wolters Village, Ltd. v. Village Properties, Ltd. (*In re* Village Properties, Ltd.), 723 F.2d 441, 444 (5th Cir. 1984).

260. *J. Catton Farms*, 779 F.2d at 1247. For a case where the equities exception was invoked because proceeds had been acquired to the detriment of general creditors, see *Nanuet Nat'l Bank v. Photo Promotional Assocs., Inc. (In re Photo Promotion Assocs., Inc.)*, 61 B.R. 936 (Bankr. S.D.N.Y. 1986). *But see In re* Bohne, 57 B.R. 461 (Bankr. D.N.D. 1985) (holding that debtor is not allowed to offset against value of bank's interest in cash collateral for expenses incurred in raising calves).

261. *See Village Properties*, 723 F.2d at 444. Secured creditors who attempted to use the equities exception to improve their positions were soundly rebuffed by the First Circuit, which stated that the equities exception "is not a general grant of equitable power permitting a court to correct a secured creditor's errors by recognizing a security interest in non-proceeds." New Hampshire Bus. Dev. Corp. v. Cross Baking Co. (*In re* Cross Baking Co.), 818 F.2d 1027, 1033 (1st Cir. 1987); *see also In re* Wynnewood House Assocs., 121 B.R. 716, 727 (Bankr. E.D. Pa. 1990) (refusing to apply the equities exception when it would benefit secured but not unsecured creditors).

262. *See* 11 U.S.C. § 363(e) (1994); *cf. supra* note 14 (discussing need to supply adequate protection when using cash proceeds from the sale of pre-petition inventory to purchase new inventory).

2. Proposed Change

The goal of affording debtors a fresh start is already implicit in § 552(a)'s cutoff of post-petition security and would be explicit under the liquidation model. Therefore, broadening the equities exception by appealing to the fresh start policy not only would, effectively, double count the impact of that policy but also would unfairly privilege the debtor's reorganization over secured creditor expectations. There is, however, an appropriate middle ground that is consistent both with the liquidation model and existing law and also with the goal of preventing depletion of the estate to the detriment of unsecured creditors.[263] *Courts should invoke the equities exception only to the extent that the debtor depletes the bankruptcy estate for the purpose of generating after-acquired collateral.*

By enhancing the debtor's ability to rehabilitate, the model provides a rationale for this middle ground. A secured creditor wants the debtor to incur costs in order to generate the post-petition collateral. Allowing the debtor to deduct these costs is necessary to motivate the debtor to generate the collateral, hoping to realize surplus collateral value once the secured creditor's debt is repaid.[264] On the other hand, the liquidation model already limits the secured creditor's ability to deprive a reorganizing debtor of the fruits of its ongoing profit-making activities. No longer is there a need for a broad equities exception.

Creating such a bright line rule for the interpretation of the equities exception would inject predictability and certainty into § 552.[265] Security interests in property are recognized entitlements. The scheme of the Code is to protect holders of collateral. The debtor, for example, often must petition the court under § 363[266] to use collateral, and only may do so after providing adequate protection to the creditor.[267] Allowing creditors to plan and bargain, knowing the pre-

263. *Cf. supra* text accompanying notes 252-53 (showing that the legislative history regards the equities exception as covering the acquisition of post-petition collateral at the expense of unsecured creditors).

264. Under U.C.C. §§ 9-502(2) and 9-504(2), "the secured party must account to the debtor for any surplus [collateral value]." U.C.C. § 9-502(2) (1995). In some cases, there may not be any surplus collateral value. A debtor that doubts the existence of a surplus can choose not to, and may reject any contractual obligations that otherwise would require it to, generate the collateral. *See* 11 U.S.C. § 365(a) (1994); *see also supra* note 217 (discussing a limitation on the liquidation model); *cf. supra* note 69 (discussing debtor's right to surplus as motivation to perform post-petition obligations).

265. *Cf. supra* note 152 and accompanying text (discussing clarity).

266. *See* 11 U.S.C. § 363.

267. *See id.* §§ 361, 363.

cise extent to which a court will protect their interests, promotes the efficient functioning of the credit economy.[268] Reimbursing the bankruptcy estate only for funds spent generating after-acquired collateral also would make the Code internally consistent.[269] Section 506(c) already provides that creditors that benefit from the preservation or disposition of their collateral must reimburse the bankruptcy estate for the necessary and reasonable costs of preserving or disposing of the collateral.[270]

It is useful to compare this proposal with the well-known *In re Delbridge* case. A Michigan bankruptcy court developed a novel approach to the interpretation of the equities exception, finding that "it is unfair to let the creditor with a pre-petition lien on milk walk away with the entire cash proceeds of milk produced largely as a result of the farmer's post-petition time, labor, and inputs .... Section 552(b) allows the court leeway to fashion an appropriate equitable remedy."[271] The *Delbridge* court suggested that the debtor and creditor were "joint venturers" and created a mathematical formula for the division of the collateral proceeds, as if they were joint venture profits.[272] *Delbridge* therefore raises the question whether the debtor is merely entitled to return of its costs (as this Article proposes) or is also entitled to a share of the profits generated by its investment of the costs. The discussion below examines that question using the methodology introduced in Part II of this Article.[273]

From the standpoint of clarity, this Article's solution of returning costs is preferable to the joint venture solution of *Delbridge*. Even the bankruptcy court that derived the profit sharing formula in

268. *See* Union Sav. Bank v. Augie Restivo Baking Co. (*In re* Augie Restivo Baking Co.), 860 F.2d 515, 519 (2d Cir. 1988).

269. *Cf. supra* notes 136-44 and accompanying text (discussing the consistency of the liquidation model with the Code).

270. *See* 11 U.S.C. § 506(c) (1994); General Elec. Credit Corp. v. Peltz (*In re* Flagstaff Foodservice Corp.), 762 F.2d 10, 12 (2d Cir. 1985); National Bank of N. Am. v. Isaac Cohen Clothing Corp. (*In re* Isaac Cohen Clothing Corp.), 39 B.R. 199 (Bankr. S.D.N.Y. 1984). Given the existence of § 506(c), one may even question the need to retain an equities exception in § 552(b). It also should be noted that where the value of the collateral is increased by less than the costs incurred by the estate, § 506(c) would limit the estate's recovery to the benefit conferred to the secured party, whereas § 552(b) and the legislative history do not impose such a limit. This Article argues that such a limit should be applicable to both sections. *See infra* note 281 and Annex A.

271. *In re* Delbridge, 61 B.R. 484, 490 (Bankr. E.D. Mich. 1986), *aff'd on other grounds sub nom.* Delbridge v. Prod. Credit Ass'n. and Fed. Land Bank, 104 B.R. 824 (E.D. Mich. 1989).

272. *See id.*

273. *See supra* note 93.

Delbridge may have misapplied it to the facts.[274] Returning costs is also preferable from the standpoint of simplicity of implementation because the amount of costs expended by the debtor is usually provable with little effort.[275] On the other hand, the joint venture solution would require a hearing and testimony in order to determine the profits to be split.[276] This Article's solution is also at least as flexible as the *Delbridge* approach: if the return of costs is insufficient to motivate the debtor to expend the costs in order to preserve or enhance the collateral's surplus value (discussed below), the debtor and the secured party can negotiate to find a mutually acceptable solution. The solution may be a joint venture sharing as in *Delbridge*, but it is not limited to that.

This Article's solution of returning costs also is consistent with commercial law, which entitles the secured party to any increase in collateral value whether or not such increase results from the debtor's actions.[277] Furthermore, it is consistent with bankruptcy law generally.[278] Section 506(c) of the Code, for example, allows a debtor to recover only the reasonable and necessary costs of preserving or disposing of collateral.[279] A default rule should be consistent with the statutes—in this case the UCC and the Code—under which it operates. In contrast, profit sharing on a joint venture basis between a

274. *See* Delbridge v. Production Credit Ass'n & Fed. Land Bank, 104 B.R. 824, 828 n.4 (E.D. Mich. 1989) (observing that the lower court transposed the "20% cash collateral figure, to which the debtors would be entitled" and the percentage of proceeds to which the secured party would be entitled). Professors LoPucki and Warren also observe that the Delbridge formula does not always produce rational results:

> [The] application of Judge Spector's formula from Delbridge to this problem produces interesting results. As we write, most hotels are appreciating in value, making the "depreciation" a negative number. When the Delbridge formula is applied to depreciating collateral, the amount that is cash collateral is also a negative number. Presumably, that means that none of the room charges can equitably be treated as cash collateral—certainly not the result that Congress and secured credit lobbyists labored so hard to bring about!

LOPUCKI & WARREN, *supra* note 82, at 91.

275. In any event, because the amount of costs expended by the debtor is only one of the variables included in the more complicated joint venture sharing formula, see *In re Delbridge*, 61 B.R. at 490, it is always simpler to determine such costs than to compute the entire formula.

276. *See id.* at 491. The costs alone of conducting such a hearing may well outweigh the benefits of a joint venture solution.

277. *See, e.g.*, U.C.C. § 9-207(2)(c) (1995). This is subject, of course, to the debtor's right to surplus after the secured party is paid in full. *See* U.C.C. § 9-502(2) (1995).

278. *See supra* text accompanying notes 269-70.

279. *See* 11 U.S.C. § 506(c) (1994). Therefore, the Code already implicitly recognizes that returning costs does not offend the policies of debtor rehabilitation and equality of distribution.

debtor and secured party has no basis in commercial law or in the Code's methodology or policy.

Perhaps the only argument in favor of the *Delbridge* approach is fairness. That argument, however, may not withstand scrutiny. It already has been noted that a debtor has no obligation to incur costs to increase collateral value. The debtor would do so only if it benefited from the increased value. The debtor, however, usually *does* benefit from the increase because it is entitled under law to any surplus collateral value once the secured party is paid on its claim.[280] For example, the debtor invests $X to improve collateral previously worth $Y. This Article proposes that the debtor be entitled to a return of the $X from the collateral proceeds, putting the debtor in no worse a position than if it had not made the investment.[281] Furthermore, if the investment increases the collateral value by more than $X, the debtor would profit from the increase when the surplus is returned.[282] If the debtor determines that the investment will not increase collateral value sufficiently, or if the secured party is undersecured so that the debtor may not realize surplus,[283] the debtor may

280. *See* U.C.C. §§ 9-502(2), 9-504(4). The *Delbridge* court may have been misinformed on that critical point. The court appeared to think that the secured party was entitled to the entire upside: "[I]t is unfair to let the creditor with a pre-petition lien on milk walk away with the entire cash proceeds of milk produced largely as a result of the farmer's post-petition time, labor, and inputs . . . ." *In re* Delbridge, 61 B.R. at 490.

281. However, to be consistent with § 506(c), and also to safeguard against a debtor's inefficient spending, the debtor's entitlement should be limited to the extent of the benefit to the secured party holding the floating lien. So if the debtor invests $X to improve collateral previously worth $Y, but the improved collateral is only worth $Y + $1/2X, the debtor would be entitled to a return of $1/2X and any eventual surplus value. *See infra* Annex A.

282. In this context, it should be observed that commercial law also protects the *value* of the debtor's surplus in the collateral. U.C.C. § 9-504(3) provides that "every aspect" of a foreclosure sale or other disposition of collateral, "including the method, manner, time, place and terms must be commercially reasonable." U.C.C. § 9-506 allows a debtor to redeem collateral prior to its disposition "by tendering fulfillment of all obligations secured by the collateral" as well as the secured party's reasonable expenses. Furthermore, the secured party cannot simply retain the collateral in satisfaction of its claim unless it takes possession of the collateral after default and notifies the debtor of its proposal to so retain the collateral, and the debtor fails to object. *See* U.C.C. § 9-505(2) (1995).

283. A secured party is undersecured if the collateral value is less than the amount of its loan. There is no surplus from an undersecured loan because the collateral is used up repaying debt. The author's experience with major bankruptcy cases involving sophisticated parties is that secured parties are rarely undersecured. Professor Lynn LoPucki, however, observed to the author that secured parties in small bankruptcy cases often may be undersecured. That at least would raise the question whether a different default rule should apply in small bankruptcy cases in order to better motivate the debtor to protect the collateral.

decide against making the investment.[284] As discussed above, the secured party then could negotiate to try to persuade the debtor to make the investment. The resulting deal may reflect a profit sharing similar to *Delbridge* but flexibility is preserved to bargain for any mutually acceptable arrangement.[285] It therefore is consistent with the liquidation model, and the balance it brings between protecting secured creditors' rights and a debtor's ability to rehabilitate, to limit the equities exception of § 552(b) to reimbursing the debtor only for the cost of generating post-petition collateral.

IV. CONCLUSION

The case law interpreting the federal bankruptcy cutoff of floating liens is ad hoc and lacks a conceptual center, reflecting a failure of existing law to distinguish two fundamentally different ways in which post-petition collateral can arise. Sometimes, pre-petition collateral changes form and is replaced by post-petition collateral. There is general agreement that the replacement collateral should be covered by a floating lien. Other times, however, post-petition collateral does *not* replace or substitute for pre-petition collateral. Existing law then has problems analyzing whether the non-replacement collateral should be covered by a floating lien. By focusing on a causation test of whether the non-replacement collateral constitutes "proceeds, product, offspring, or profits" of pre-petition collateral, existing law often becomes confused in semantics and ambiguities. As a result, the outcomes can be unpredictable.

To analyze whether a floating lien *should* cover non-replacement collateral, one must balance the bankruptcy policy favoring debtor rehabilitation with a secured creditor's right to its contractual bargain where rehabilitation is not impeded. This Article proposes that a liquidation model can be used to achieve that balance. Furthermore,

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284. One might intuitively think of the debtor's motivation to make an investment in collateral by analogy to a shareholder's motivation to invest in a wholly-owned corporation. The debtor, like the corporate shareholder, is the residual claimant of the asset. If the corporation is solvent, the shareholder then may well decide to protect its residual value by investing more. That would be analogous to the typical case of a debtor protecting collateral. But if the corporation is insolvent, the residual is (and additional investments may be) worthless; the shareholder then would have little motivation to throw good money after bad. That would be analogous to a debtor deciding whether to protect collateral where the secured party is undersecured.

285. The arguments in favor of returning costs are even more compelling in the context of the liquidation model than under existing § 552(b). That is because the model limits the circumstances under which a floating lien would apply, so the analogy is much closer to § 506(c)'s preservation of pre-petition collateral than to sharing profits of an ongoing business venture.

outcomes under the model are more certain than under the current case law melange. Thus, capital is available to risky but worthwhile ventures, and both creditors and debtors benefit from a more stable credit economy. In addition, investors and rating agencies will be able to better assess the risks of commercial and financial transactions—such as asset securitizations—that depend on future-arising assets for repayment.

The liquidation model also significantly reduces the need for an equities exception under § 552(b). Because the post-petition application of the floating lien is more focused under the model, there is less room for judicial discretion. However, the debtor may incur costs even in liquidation in order to generate post-petition collateral, and therefore should be able to recover those costs to the extent of the benefit to the holder of the floating lien.

Because the language of § 552 is broad, courts could choose to apply the liquidation model without amending the existing statute.[286] That, however, still leaves in place statutory language that is ambiguous on its face. It therefore would be preferable to refine the text of § 552. Annex A to this Article proposes statutory language to accomplish that.

Although the liquidation model is likely to encourage commercial and financial transactions that rely on future cash flows from financial assets,[287] this Article does *not* depend upon a claim that the liquidation model will stimulate more overall business activity than any competing approach. Business activity must be balanced with the bankruptcy policy of debtor rehabilitation. Is the liquidation model the highest valued balance of post-petition value to rehabilitating debtors and pre-petition loss to secured creditors? Because the gain and loss are to different parties and the likelihood of debtor rehabilitation is dependent on a multitude of factors, the answer may well be unknowable. Some therefore may argue that the balance reached in this Article is ultimately arbitrary, and that other balances could be reached—some more pro-debtor, others more pro-creditor. That, however, would miss the central point of this Article: A systematic, predictable and consistent approach to reaching a balance is desirable. The liquidation model provides such an approach and opens a dialogue on whether that approach is optimal.

286. A court could, for example, use the liquidation model to give meaning to the phrase "proceeds, product, offspring, or profits" under § 552.

287. *See supra* notes 23-28 and accompanying text.

ANNEX A

A Proposal to Amend Section 552 of the Federal Bankruptcy Code (11 U.S.C. § 552)* to Implement the Liquidation Model

Section 552. Post-petition effect of security interest.

(a) Except as provided in subsection (b) of this section, property acquired by the estate or by the debtor after the commencement of the case is not subject to any lien resulting from any security agreement entered into by the debtor before the commencement of the case. [No change.]

(b) Except as provided in sections 363, 522, 544, 545, 547, and 548 of this title, if the debtor and an entity entered into a security agreement before the commencement of the case and if the security interest created by such security agreement extends to after-acquired property of the debtor, then such security interest extends to such property of the debtor acquired after the commencement of the case to the extent provided by such security agreement and by applicable non-bankruptcy law, but limited to the extent such after-acquired property (i) replaces or substitutes for the pre-petition collateral, or (ii) would be acquired by the estate even if the case were a case under Chapter 7 of this title.

(c) The trustee may recover from post-petition collateral otherwise permitted under this section the reasonable and necessary costs and expenses, in addition to those referred to in section 506(c), of generating such collateral to the extent of any benefit to the entity secured by such collateral.

* Section 549 of the *Federal Bankruptcy Code* (11 U.S.C. § 549, dealing with post-petition transactions) also should be amended to clarify that it is subject to § 552(b).

ANNEX B

Illustrative Differences in Outcomes Between Existing Law and the Liquidation Model

Note to Reader: This Annex summarizes the differences in outcomes discussed in the Article and is subject to the Article's more complete description.

- *Dividends.* Existing law is ambiguous as to whether a floating lien covers stock dividends. The liquidation model covers most dividends.
- *Inventory.* Probably no difference other than the "equities" exception discussed below, except the liquidation model clarifies that a floating lien covers second generation proceeds.
- *Contracts.* The few cases decided under existing law have given very little explanation for their outcomes. The liquidation model provides a rationale for the outcomes.
- *Equipment Leases and Equipment.* No difference other than the equities exception.
- *Hotel Revenues.* Existing law appears to recognize a floating lien on hotel room rentals even if the creditor is not secured by the hotel building. The liquidation model does not.
- *All Assets of a Company.* Existing law may recognize a floating lien on all post-petition assets of the company. The liquidation model views the company as merely an aggregate of individual liquidating assets, so the floating lien does not attach to post-petition "going concern" value.
- *Milk from a Cow.* Existing case law is divided as to whether a floating lien on post-petition milk should be recognized in bankruptcy. The liquidation model would recognize such a lien.
- *Equities Exception. This qualifies all of the above categories.* Under existing law, a judge has discretion, "based on the equities of the case," to cut off a floating lien that is otherwise specifically allowed. The liquidation model, by more clearly defining what a floating lien covers, would reduce this discretion and allow a judge only to cut off the reasonable and necessary costs and expenses of generating the collateral.

ANNEX C

Index to Significant Concepts

This Annex refers the reader to portions of the Article that explain significant concepts.

- Explanation of the liquidation model, and its two step test. Introduction, at 411-14; Part I.C, at 423-25.
- Application of the liquidation model. Part III.B.1, at 443-45.
- Distinction between the existing legal standard of "proceeds, product, offspring or profits" and the liquidation model. Part I.C, at 423-25.
- Distinction between tracing and the liquidation model. Part I.C, at 422-25.
- Assumptions and qualifications underlying the liquidation model. Introduction, at 412-14.
- Application of the liquidation model to collateral leased post-petition. Part III.B.2, at 447-48; Part III.B.4, at 452-53.
- Application of the "equities" exception to the liquidation model. Part III.C.2, at 462-66.
- Definition of "liquidating collateral." Part I.C, at 422.
- Definition of "non-liquidating collateral." Part I.C, at 422. Compare Part III.B.1, at 444-45.
- Definition of "replacement collateral." Part I.C, at 422.
- Definition of "non-replacement collateral." Part I.C, at 422. Compare Part III.B.1, at 444-45.
- Does the liquidation model apply to generic categories, or specific items, of collateral? Part III.B.2, at 447.
- How to determine what collateral would be acquired by a debtor in a liquidation. Part III.B.1, at 444-45.
- Operation of the debtor in a liquidation. Part I.C, at 420-21.
- Simplified assumption as to the period of a debtor's liquidation. Part III.B.1, at 445.
- Distinction between the liquidation model and a valuation test. Part I.B, at 419 n.72; Part II.D, at 439.
- Relationship between the liquidation model and collateral depreciation. Introduction, at 412-13.