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Equipment Lessors And Secured Parties In Bankruptcy: An Argument For Coherence

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EQUIPMENT LESSORS AND SECURED PARTIES IN BANKRUPTCY: AN ARGUMENT FOR COHERENCE

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I. INTRODUCTION

Whether a company in need of a piece of equipment leases it or buys it on credit is most likely determined by factors other than projection of the treatment that transaction will receive should bankruptcy occur.[1] The decision whether to lease or to purchase on credit, however, carries significant ramifications if the purchasing company becomes a debtor under the Bankruptcy Code (Code).[2] This is true even though leased equipment and equipment encumbered by a security interest serve virtually identical economic functions for the business.[3] Currently, these transactions are treated very differently under both state law[4] and bankruptcy law,[5] although their

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1. Equipment is leased, rather than purchased, primarily because of the available tax benefits (which may, in fact, be less favorable currently than was previously the case), see Land, *Federal Income Tax Consequences in Leasing Transactions*, in BASICS OF EQUIPMENT LEASING 443 (Practicing Law Inst. No. 4A-4183, 1987); Macan & Umbrecht, *Tax Aspects of Equipment Leasing*, in 1 EQUIPMENT LEASING—LEVERAGED LEASING 313 (B. Fritch, A. Reisman & I. Shrank eds. 3d ed. 1988); and because of the opportunity for off-balance-sheet financing, see Monson, *Accounting for Leases*, in BASICS OF EQUIPMENT LEASING, *supra*, at 403; Deiter, Stewart & Giroux, *Accounting for Leases*, *in* 1 EQUIPMENT LEASING—LEVERAGED LEASING, *supra*, at 633.

2. Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 (codified at 11 U.S.C. §§ 101-1330), *as amended by* Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, 98 Stat. 333 (codified as amended in various sections of 11 U.S.C. and 28 U.S.C.); Bankruptcy Judges, United States Trustees and Family Farmer Bankruptcy Act of 1986, Pub. L. No. 99-554, 100 Stat. 3088 (codified as amended in various sections of 11 U.S.C. and 28 U.S.C.); Retiree Benefits Bankruptcy Protection Act of 1988, Pub. L. No. 100-334, 102 Stat. 610 (codified as amended in various sections of 11 U.S.C.); Intellectual Property Licenses in Bankruptcy, Pub. L. No. 100-506, 102 Stat. 2538 (codified at 11 U.S.C. §§ 101 & 365(n) (1988)); Municipal Bankruptcy Amendments, Pub. L. No. 100-597, 102 Stat. 3028 (amending 11 U.S.C. § 101(31) and various sections of Chapter 9 of Title 11); An act to amend Title 11 of the United States Code regarding Swap Agreements and Forward Contracts, Pub. L. No. 101-311, 104 Stat. 267 (codified as amended in various sections of 11 U.S.C.).

3. *Cf. In re* Martin Bros. Toolmakers, Inc., 796 F.2d 1435, 1439 (11th Cir. 1986) ("[A] real estate lease . . . may be the functional equivalent of a secured financing transaction.").

4. Article 9 of the Uniform Commercial Code (U.C.C.) applies to leases "intended as security." U.C.C. § 9-102(2) (1972). Thus, a "true lease" is not subject to Article 9. J. WHITE & R. SUMMERS, UNIFORM COMMERCIAL CODE § 21-3 (3d ed. 1988). See the discussion of true leases *infra* text accompanying notes 45-51.

5. For a discussion of the treatment of these transactions in bankruptcy, see *infra* text accompanying notes 15-92.

similarities in functional terms may be much greater than their differences. If that is true, one must question whether the bankruptcy statute should continue its present pattern.[6] In fact, two bankruptcy policies—treating similarly situated creditors equally and encouraging reorganization—may be reasons for treating these functionally similar financing devices alike once bankruptcy ensues.[7]

The thesis of this Article is that analysis of the various interests of lessors and secured parties demonstrates no differences between them sufficient to justify the divergent treatment bankruptcy accords. The expectations of both lessors and secured parties, to be protected in bankruptcy, should be measured by the value of the rights of each under state law as if the debtor simply walked away from the respective transactions. The secured party would take the collateral, realize its current value through resale, and pursue the debtor for any deficiency. In bankruptcy, these rights are replicated by a secured claim in the amount of the value of the collateral (which must be paid by handing over the property or its value in cash or by making a stream of payments having a present value equal to the value of the property) and an unsecured claim for the difference. The lessor whose debtor simply walked away would enjoy similar rights. The lessor would retake the goods, realize their value by sale or another lease, and pursue the debtor for the difference between the amount realized and the original lease price. This Article takes the position that lessors should be treated the same way that secured parties are treated in bankruptcy—that is, debtors who want to keep and use leased equipment should be required to pay the lessor the value of the equipment, either in a lump sum or in a stream of payments having a present value of that amount. In addition, debtors who use equipment pending confirmation of a plan should be required to give the lessor adequate protection against depreciation.

This Article begins by describing similarities and differences in bankruptcy's treatment of equipment lessors and secured parties.[8] It then explores reasons for the differing bankruptcy treatment currently accorded those parties, examines characteristics of the contract and property rights of the parties,[9] and analyzes the economic characteristics of those transactions.[10]

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6. Other authors are currently struggling to rationalize the Siamese twin of leases—executory contracts. Andrew, *Executory Contracts in Bankruptcy: Understanding "Rejection"*, 59 U. Colo. L. Rev. 845 (1988); Westbrook, *A Functional Analysis of Executory Contracts*, 74 Minn. L. Rev. 227 (1989). The proposal suggested by this Article would uncouple the two as far as equipment leases are concerned, and leave § 365 applicable primarily to leases of real estate.

7. Adherence to the economic realities of a transaction, rather than to its form or the parties' "intent," is shown in the revised version of § 1-201(37) of the U.C.C. In defining whether a lease is a disguised security interest, the new provision omits the reference found in the former version to lease transactions "intended as security" and, instead, describes transactions that are and are not leases on the basis of their economic characteristics. The relevant language is quoted *infra* note 50.

8. *See infra* text accompanying notes 15-92.

9. *See infra* text accompanying notes 93-123.

10. *See infra* text accompanying notes 124-52.

Third, the Article examines the Supreme Court cases that have provided the foundation upon which those differences were built.[11] Finally, the Article recommends that equipment lessors in a lessee's bankruptcy be treated as secured parties are treated in their debtor's bankruptcy[12] and describes how such unitary treatment should be accomplished.[13]

The argument that bankruptcy should not alter state law entitlements of nonbankrupt parties is currently fashionable.[14] Obviously, the position presented here is to the contrary. This Article's intention is not to assert that bankruptcy may cavalierly disregard state law entitlements. Rather, the intention is to show that no considerations other than the appropriate scope of bankruptcy's adherence to state law entitlements constrain the changes proposed here. This focuses the question, then, on whether bankruptcy should follow state law distinctions that may themselves be irrational because they are not supported by relevant differences.

II. Current Treatment in Bankruptcy[15]

A. *Security Interests*

A company in need of a certain piece of equipment may decide, for reasons unrelated to bankruptcy, to purchase the item on credit. If the seller is unwilling to accept the buyer's bare promise to pay later, the buyer will probably grant the seller a security interest in the equipment, in accordance with the provisions of Article 9 of the Uniform Commercial Code (U.C.C.).

If the buyer-debtor subsequently defaults on this obligation, but does not file bankruptcy, the secured party can accelerate the debt[16] and become

11. *See infra* text accompanying notes 153-209.

12. If more consistent treatment is called for, one question is why lessors should be treated as secured parties, rather than treating secured parties as lessors. As will be developed, the current bankruptcy treatment accorded lessors is generally more favorable than that given secured parties. To extend this more generous treatment to secured parties would drain the bankruptcy estate and undermine the possibility of successful reorganization in too many cases. It would permit secured parties to exercise their in rem rights to repossess their collateral, thus depriving bankruptcy estates of property necessary to effective reorganizations and defeating the overriding bankruptcy policy of encouraging reorganization.

13. *See infra* text accompanying notes 210-24.

14. *See, e.g.*, T. Jackson, The Logic and Limits of Bankruptcy Law 21-27 (1986). *See infra* note 224.

15. This description is not intended to be a complete and exhaustive recitation of bankruptcy's handling of secured claims or of leases. Rather, the discussion here seeks to highlight that treatment in the context of equipment transactions, in order to refresh the memory of the already-familiar reader and to sketch a broad outline for the novice. For more complete descriptive treatments, see B. Weintraub & A. Resnick, Bankruptcy Law Manual ¶ 5.11, at 5-51 to 5-63, ¶ 7.10, at 7-54 to 7-74, ¶ 8.23, at 8-111 to 8-115 (rev. ed. 1986); L. King, K. Klee, & R. Levin, 2 Collier on Bankruptcy ¶¶ 365.10 to 365.13 (15th ed. 1987) [hereinafter Collier].

16. Parties to a security agreement define the events that will constitute default thereunder. A clause that accelerates the obligation upon default is so common and so useful to the creditor that its omission should raise questions about the quality of the secured party's legal representation.

entitled either to full payment of the balance[17] or to possession of the equipment.[18] Upon repossession, the secured party can sell the equipment for its current value and look to the buyer-debtor for any deficiency.[19]

If the buyer-debtor files bankruptcy instead and the debt exceeds the value of the collateral, the creditor is treated as the holder of two claims—one secured and one unsecured.[20] The creditor is stayed from any collection action[21] (whether the debtor seeks liquidation under Chapter 7 or reorganization under Chapter 11),[22] but the creditor's prospects beyond that are different under the two chapters.

The secured creditor's treatment in Chapter 7 is fairly straightforward.[23] If the creditor is undersecured, as often happens in the case of equipment, the equipment has no value to the estate, and a Chapter 7 trustee is likely to abandon the property.[24] The secured creditor will be able to pursue his right to repossess and sell the collateral,[25] although the unsecured portion

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17. Assume that the cash price of equipment is $100,000 and the buyer agrees to pay $1200 per month for 10 years. If default occurs five years after the sale, the remaining balance would be $72,000—*i.e.*, five years of remaining payments, at $1200 per month. (For the sake of simplicity, reduction to present value will be disregarded throughout this Article).

18. U.C.C. §§ 9-501(1) & 9-503.

19. If under the hypothetical presented in note 17, *supra*, the equipment had a present value of $60,000, the deficiency would be $12,000.

20. Section 506(a) of the Bankruptcy Code provides that "[a]n allowed claim of a creditor secured by a lien on property in which the estate has an interest . . . is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property." Phrased less elaborately, § 506(a) measures the amount of the secured claim by the value of the collateral. The creditor in the hypothetical presented above would have a secured claim of $60,000 and an unsecured claim of $12,000.

Valuation is a difficult and frequently litigated issue in bankruptcy. The secured creditor is exposed to valuation determinations that may be lower than anticipated, thus resulting in smaller secured claims and proportionately larger unsecured claims. White, *Efficiency Justifications for Personal Property Security*, 37 VAND. L. REV. 473, 504-05 n.70 (1984). That, in turn, is important to issues such as adequate protection, see *infra* note 29 and accompanying text, and cram down, see *infra* notes 32-36 and accompanying text.

21. 11 U.S.C. § 362(a) (1988).

22. The two chapters do not present a perfect dichotomy, since liquidation can be accomplished under Chapter 11, 11 U.S.C. § 1123(b)(4) (1988), and the debtor's business can be operated (albeit for a limited time) under Chapter 7, 11 U.S.C. § 721 (1988).

23. This discussion of the secured creditor's treatment in bankruptcy assumes that the security interest is perfected. If it is not, the creditor will lose his security interest to one or more of the trustee's avoiding powers. *See infra* notes 45-46 and accompanying text.

24. 11 U.S.C. § 554 (1988).

25. A bit of complication surrounds this seemingly simple proposition. In *In re* Bell, 700 F.2d 1053 (6th Cir. 1983), debtors remained current in their payments on a van, which was subject to a purchase money security interest, both before and during their Chapter 7 case. The trustee abandoned the van and the creditor sought to repossess it under a provision in the security agreement defining the filing of bankruptcy as an event of default. Debtors argued that they could keep the van, despite the clause and without having to reaffirm the debt or redeem the collateral, as long as they made the payments. The court held, however, that the creditor could take the collateral, upon obtaining relief from the automatic stay (which would

of his claim will be discharged. Thus, the secured creditor gets the collateral itself or its value[26] and takes a pro rata share on the unsecured portion of his claim along with the other unsecured creditors.

If a Chapter 11 case is filed, however, things become more interesting. A debtor-in-possession that is attempting to reorganize is likely to conclude that this piece of equipment is necessary to those efforts. That being the case, the secured party may not be able to lift the automatic stay and take back his collateral.[27] Moreover, if the creditor repossessed the equipment following default by the debtor, but did not complete a sale before bankruptcy was filed, he may have to return the equipment to the reorganizing debtor.[28] In either case, the creditor will have to stand by while the debtor uses the collateral, watching as it depreciates in value. The creditor is compensated for that depreciation under the adequate protection provisions of the Code,[29] but, pending confirmation of a plan, that is the sum total

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be easy to get under § 362(d)(1)).

Other courts have disagreed with this portion of *Bell*'s holding. The court in *In re* Peacock, 87 Bankr. 657 (Bankr. D. Colo. 1988), for example, said that *Bell* has been criticized for its holding that a creditor can either get immediate possession or force a debtor whose payments are current to redeem or reaffirm. *See also* Lowry Fed. Credit Union v. West, 882 F.2d 1543 (10th Cir. 1989) (when neither debtor nor creditor is prejudiced, because payments are current and there is no significant disparity between the value of the collateral and the amount of the debt, the court may allow debtor to retain the collateral conditioned upon performance of the duties in the security agreement). *But see In re* Edwards, 401 F.2d 1383, 1386-87 (7th Cir. 1990), distinguishing and criticizing *Lowry*.

26. The trustee may sell the equipment himself, rather than abandon it, and he will certainly do so if the value of the equipment exceeds the debt. In that case, the secured creditor will receive the amount of the secured claim.

27. The secured creditor is entitled to relief from the stay if the debtor lacks equity in the property and, in addition, the property is not needed for an effective reorganization. 11 U.S.C. § 362(d)(2) (1988). Because we are assuming that equipment is necessary to a reasonable reorganization effort, even an undersecured creditor cannot obtain relief under this subsection.

28. In United States v. Whiting Pools, Inc., 462 U.S. 198 (1983), the Internal Revenue Service seized substantially all of debtor's property (equipment, vehicles, inventory, and office supplies) pursuant to a tax lien. Debtor filed Chapter 11 the next day and, when the IRS moved for relief from the stay in order to sell the property, counterclaimed for an order under § 542(a) requiring the IRS to return the seized property to the bankruptcy estate. The Court held that § 542(a) brings into the estate property in which the debtor did not have a possessory interest as of the time bankruptcy was filed, and noted that "[a]s does all bankruptcy law, § 542(a) modifies the procedural rights available to creditors to protect and satisfy their liens." *Id.* at 206 (footnote omitted).

29. 11 U.S.C. §§ 361, 362(d)(1) & 363(e) (1988). An undersecured creditor is entitled to this compensation if depreciation erodes the value of the collateral and, therefore, the amount of the secured claim. If the creditor subjected to depreciation is oversecured, depreciation eats away at his equity cushion but does not immediately reduce the amount of the secured claim. In this situation, courts split on the question of his entitlement to adequate protection. *In re* Alyucan Interstate Corp., 12 Bankr. 803 (Bankr. D. Utah 1981), held that the creditor is not entitled to adequate protection until the value of the collateral declines to the amount of the debt, thus threatening the amount of the secured claim. An apparent majority of courts, however, hold that an oversecured creditor is not adequately protected if the equity cushion is being eroded by depreciation or by interest accruing on a senior claim. *See, e.g., In re* Johnson, 90 Bankr. 973, 979 n.4 (Bankr. D. Minn. 1988).

of the secured party's rights. The Supreme Court's decision in *United Savings Association of Texas v. Timbers of Inwood Forest Associates, Ltd.*[30] makes clear that an undersecured creditor cannot claim compensation for the lost opportunity to repossess, sell the collateral, and reinvest the proceeds. Thus, bankruptcy honors the value of the secured party's rights in collateral; it does not compensate him for the full economic value of his state law rights or honor his in rem rights.

The plan may propose any degree of disadvantage to a class of creditors that votes for it, but the Code sets forth minimum requirements for the treatment that must be accorded an impaired[31] class that rejects the plan. These are the standards for "cram down."[32] A creditor holding a claim secured by the debtor's equipment who insists on the best treatment the debtor-in-possession can be forced to give is entitled to retain his lien on the equipment and to receive a stream of payments having a value, as of the date of the plan, of the amount of the secured claim.[33] The debtor-in-possession can alter the agreement originally entered into with the secured party by reducing the amount of the monthly payment, changing the payment schedule, extending the term of the obligation, and lowering the interest rate.[34] Similarly, the unsecured claim, if classified in an impaired

30. 484 U.S. 365 (1988). In *Timbers*, an undersecured creditor sought to recover the use value of collateral that the creditor was stayed from repossessing. Approaching statutory construction as "a holistic endeavor," *id.* at 371, the Court held that the phrase "interest in property" as used in § 362(d)(1) does not include "the notion of 'right to immediate foreclosure.'" *Id.*

31. A class is impaired by a plan unless it: 1) "leaves unaltered the legal, equitable, and contractual rights" to which class members are entitled; 2) cures pre- and post-petition defaults that led to acceleration of the debt, and reinstates the obligation; or 3) cashes out the creditor. 11 U.S.C. § 1124 (1988).

32. 11 U.S.C. § 1129(b)(2)(A) (1988). If the plan cures defaults and does not otherwise alter the lienor's "legal, equitable, and contractual rights," the lienor does not even have the opportunity to object; his claim is unimpaired, 11 U.S.C. § 1124 (1988), and he will be deemed to have accepted the plan, 11 U.S.C. § 1129(a)(8) (1988). If the plan does alter the lienor's nonbankruptcy rights, cram down allows the debtor to reinstate his prepetition obligations even over the affected lienor's objection. The legislative history justifies these rules on the grounds that "[t]he holder of a claim or interest who under the plan is restored to his original position, when others receive less or get nothing at all, is fortunate indeed and has no cause to complain." S. Rep. No. 989, 95th Cong., 2d Sess. 120 (1978), *reprinted in* 1978 U.S. Code Cong. & Admin. News 5787, 5906 [hereinafter Senate Report]. Dean Jackson took issue with this justification, arguing that the creditor may have bargained for the opportunity to call in a below-market loan upon the debtor's bankruptcy and to reloan at the then-prevailing market rate. Jackson, *Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain*, 91 Yale L.J. 857, 885-86 (1982).

33. 11 U.S.C. § 1129(b)(2)(A)(i)(I) & (II) (1988). Under the hypothetical presented above, *supra* note 17, the secured claim would be $60,000.

In the alternative, the plan can provide for sale of the collateral free of the lien, with the lien to attach to the sale proceeds, 11 U.S.C. § 1129(b)(2)(A)(ii) (1988), or for realization by the creditor "of the indubitable equivalent of" his claim. 11 U.S.C. § 1129(b)(2)(A)(iii) (1988). The latter language is derived from *In re* Murel Holding Corp., 75 F.2d 941, 942 (2d Cir. 1935). Senate Report, *supra* note 32, at 5913.

34. Although the nonconsenting secured party is assured at least as much as the allowed

class that has rejected the plan, must receive a stream of payments having a value, as of the effective date of the plan, of the allowed amount of the unsecured claim.[35] If the plan provides for less, then equity interests receive nothing.[36]

B. Leases Compared

The purchaser of equipment may choose, for reasons unrelated to bankruptcy, to lease rather than purchase. Outside of bankruptcy, the lessor can cancel the lease contract upon the lessee's default[37] and sell or re-lease the equipment.[38] The lessor apparently can recover the present value of the rent provided in the agreement only if the lessor is unable to dispose of the goods at a reasonable price after having made reasonable efforts to do so.[39]

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amount of his secured claim, 11 U.S.C. § 1129(a)(7)(A), "section 1129 clearly provides that a debtor with a continuing cash flow problem may use the creditor as an involuntary financier." Ayer, *On the Vacuity of the Sale/Lease Distinction*, 68 IOWA L. REV. 667, 694 (1983).

35. 11 U.S.C. § 1129(b)(2)(B)(i) (1988). Under the hypothetical presented in note 17, *supra*, the allowed amount of the unsecured claim is $12,000.

36. 11 U.S.C. § 1129(b)(2)(B)(ii) (1988).

37. Uniform Commercial Code, Article 2A—Leases § 2A-505, Proposed Final Draft (Oct. 1, 1987). The remedies provisions of Article 2A are drawn from Articles 2 and 9 and from the common law. Article 2A distinguishes between a "statutory default," U.C.C. § 2A-523(1), which includes a failure to make payments when due, and a "contract default," which is not defined in Article 2A, but includes defaults as defined in the lease agreement. The discussion in the text assumes that a statutory default has occurred.

For a more complete discussion of lessor's remedies under Article 2A, see Benfield, *Lessor's Damages Under Article 2A After Default By the Lessee as to Accepted Goods*, 39 ALA. L. REV. 915 (1988); Cooper, *Personal Property Leasing Under Article 2A*, in 2 EQUIPMENT LEASING—LEVERAGED LEASING, *supra* note 1, at 1047, 1191-1213.

38. U.C.C. § 2A-527(1). The lessor need not take possession of leased goods in order to dispose of them. U.C.C. § 2A-527 comment.

The new lease may be on terms similar to or different from those of the original lease. If disposition is by a lease "substantially similar to the original lease agreement," the lessor can recover "the present value as of the date of default of the difference between the total rent for the remaining lease term of the original lease agreement and the total rent for the lease term of the new lease agreement." U.C.C. § 2A-527(2). If disposition is by sale or by a lease that is not "substantially similar to the original lease agreement," the lessor can recover "the present value as of the date of default of the difference between the total rent for the remaining lease term of the original lease agreement and the market rent at the time and place for tender computed for the same lease term." U.C.C. § 2A-528(1).

In both cases, the lessor can also recover "accrued and unpaid rent as of the date of default" and "any incidental damages allowed under Section 2A-530, less expenses saved in consequence of the lessee's default." U.C.C. §§ 2A-527(2) & 2A-528(1).

39. Section 2A-529(1)(b) of the U.C.C. seems to so provide, although the provisions of Article 2A are not entirely clear.

Whether or not the new lease is on terms substantially similar to those of the original lease, the lessor can also recover "accrued and unpaid rent as of the date of default" and "any incidental damages allowed under Section 2A-530, less expenses saved in consequence of the lessee's default." *Id.* If the lessor proceeds under this section, the lessor must hold repossessed goods for the benefit of the lessee during the remaining lease term, in order to prevent double recovery that would occur if the lessor both sued for the rent and disposed of

These rules seem to impose at least some[40] mitigation requirements[41] upon lessors akin to those imposed upon sellers,[42] and grant to lessors rights that substantially duplicate those enjoyed by secured parties upon their debtors' default.[43]

If the lessee files bankruptcy, the consequences for the nonbankrupt lessor are substantially different than the consequences for the nonbankrupt secured party, even though the particulars of the two transactions are substantially the same. The first hurdle to be cleared is to determine whether this lease is a "true lease" or a lease intended as security.[44] A transaction will be treated as creating a security interest if the parties' agreement disguises a security arrangement in lease garb. In that case, the transaction will not be governed by section 365 of the Bankruptcy Code. Rather, it will be subject to Article 9 of the U.C.C.,[45] and the lessor who failed to file a

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the goods before the end of the remaining term. U.C.C. § 2A-529(2)-(4).

The lessor also has an action for the price if the lessee has accepted the goods. U.C.C. § 2A-529(1)(a). By its terms, the subsection seems to be applicable even though the goods are not in the possession of the lessor. As one Code commentator has pointed out, however, the lessor can recover possession of goods from the lessee under §§ 2A-523(1)(c) & 2A-525(2) and, therefore, may be in possession of goods that previously were accepted by the lessee. Cooper, *supra* note 37, at 1210.

40. Professor Cooper noted that mitigation does not seem to be required when the lessee has previously accepted goods:

> The problem is that subsection [2A-529](1)(a) does not expressly require the lessor who has repossessed previously accepted goods to make a reasonable effort to dispose of them. On one hand, the right to repossess the goods clearly is required to make the lessee [sic—lessor?] whole, even where an action for rent is permitted, since the lessor would have received both rent and return of the residual if the contract had been performed. On the other hand, it seems anomalous to permit a lessor to recover rent after repossessing the goods without requiring any mitigation, while requiring mitigation efforts from a lessor who has merely identified, but not delivered, the goods. Under the literal language of the section, however, a repossessing lessor of accepted goods has no duty to mitigate as a prerequisite to a rent recovery action, while a lessor who has identified goods prior to delivery has an obligation to make reasonable efforts to dispose of the goods before making a claim for rent.

Cooper, *supra* note 37, at 1210. Professor Cooper argued that "[a] better reading of the section would require reasonable efforts to dispose of the goods in every case where the lessor is in possession of goods . . . and would permit an action for rent in the absence of mitigation efforts only when the goods are not in the possession of the lessor or have been destroyed after risk of loss passed to the lessee." *Id.* 1210 n.907. Professor Cooper also noted that a committee of the California bar recommended changes in that state's version of § 2A-529(1) to remedy this problem.

41. Under the modern view of a lease as a contract, mitigation is required. Compare this with the view taken by the RESTATEMENT (SECOND) OF PROPERTY § 12.1(3) (1976), under which the lessor has no duty to mitigate.

42. Under U.C.C. § 2-709(1)(b), a seller may recover the price of goods only if he "is unable after reasonable effort to resell them at a reasonable price."

43. The comment to U.C.C. § 2A-527 cross references U.C.C. § 9-507.

44. This is also the first hurdle to be cleared outside of bankruptcy, if priority is an issue.

45. Article 2A excludes retention or creation of a security interest from the definition of a lease. U.C.C. § 2A-103(1)(j). Article 9, on the other hand, applies generally "to any

financing statement conforming with its requirements will be rendered an unsecured creditor by the trustee's avoiding powers.[46] If, on the other hand, this lease is a "true lease," it will be governed by section 365 of the Bankruptcy Code and will receive the special treatment elaborated below.[47]

Whether a particular lease is a true lease or a lease intended for security is determined, even for bankruptcy purposes, under state law standards set out chiefly in section 1-201(37) of the U.C.C.[48] A 1987 amendment added several paragraphs to that subsection in an effort to clarify the "considerable confusion"[49] that had existed in the courts.[50] Although the result is a

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transaction (regardless of its form) which is intended to create a security interest in personal property," U.C.C. § 9-102(1)(a), and specifically to a "lease . . . intended as security," U.C.C. § 9-102(2). Thus, true leases are subject to Article 2A of the U.C.C. and Article 9 will apply to a transaction denominated a lease that is instead found to be a lease disguised as security. Under Article 9, an attached, but unperfected, security interest is enforceable against the debtor. U.C.C. § 9-203(2). As a general proposition, however, the security interest must be perfected in order for the secured party to prevail against third parties who also claim an interest in the goods. The trustee is such a party, and will defeat the interest of a nominal lessor whose transaction is subject to Article 9 and who failed to perfect in accordance with its requirements. U.C.C. § 9-301(1)(b) & (3).

46. Pacific Express, Inc. v. Teknekron Infoswitch Corp. (*In re* Pac. Express, Inc.), 780 F.2d 1482 (9th Cir. 1986). Under 11 U.S.C. § 544(a), a trustee can avoid any transaction that is avoidable by a judicial lien creditor. Since such a creditor can take priority over an unperfected security interest, U.C.C. § 9-301(1)(b), the trustee can avoid the security interest. That claim then falls into the ranks of the unsecured.

An unperfected security interest may also be avoidable as a preference under 11 U.S.C. § 547. A transfer unperfected at the moment of bankruptcy filing is deemed by § 547(e)(2)(C) to have been made immediately before the filing. This subsection effectively places the transfer within the 90-day preference period, rendering it avoidable. As before, the claim becomes unsecured.

A true lessor, on the other hand, is not vulnerable to attack under either § 544(a) or § 547.

47. *See infra* notes 57-92 and accompanying text.

48. The origin of this linkage—*i.e.*, that a lease determined to be a disguised security arrangement for Article 9 purposes is also magically removed from the reach of § 365—is unclear. The law, however, *is* clear. *Pacific Express*, 780 F.2d at 1486-88; Pac West Auction Co. v. Falk Farms, Inc. (*In re* Falk Farms, Inc.), 88 Bankr. 254 (Bankr. 9th Cir. 1988); *In re* Mesa Refining Inc., 52 Bankr. 359 (Bankr. D. Colo. 1985); *In re* Holywell Corp., 51 Bankr. 56 (Bankr. S.D. Fla. 1985).

49. U.C.C. § 1-201(37) comment 37.

50. The language added to § 1-201(37) is as follows:

> Whether a transaction creates a lease or security interest is determined by the facts of each case; however, a transaction creates a security interest if the consideration the lessee is to pay the lessor for the right to possession and use of the goods is an obligation for the term of the lease not subject to termination by the lessee, and
> (a) the original term of the lease is equal to or greater than the remaining economic life of the goods,
> (b) the lessee is bound to renew the lease for the remaining economic life of the goods or is bound to become the owner of the goods,
> (c) the lessee has an option to renew the lease for the remaining economic life of the goods for no additional consideration or nominal additional consideration

substantially more comprehensive statutory standard, for our purposes the presence of a residual having genuine economic value is the key.[51]

A lessor who has anticipated a bankruptcy filing, or otherwise been quick to move against a defaulting debtor, and has asserted rights to terminate the lease is in a much stronger position than the secured creditor

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upon compliance with the lease agreement, or

(d) the lessee has an option to become the owner of the goods for no additional consideration or nominal additional consideration upon compliance with the lease agreement.

A transaction does not create a security interest merely because it provides that

(a) the present value of the consideration the lessee is obligated to pay the lessor for the right to possession and use of the goods is substantially equal to or is greater than the fair market value of the goods at the time the lease is entered into,

(b) the lessee assumes risk of loss of the goods, or agrees to pay taxes, insurance, filing, recording, or registration fees, or service or maintenance costs with respect to the goods,

(c) the lessee has an option to renew the lease or to become the owner of the goods,

(d) the lessee has an option to renew the lease for a fixed rent that is equal to or greater than the reasonably predictable fair market rent for the use of the goods for the term of the renewal at the time the option is to be performed, or

(e) the lessee has an option to become the owner of the goods for a fixed price that is equal to or greater than the reasonably predictable fair market value of the goods at the time the option is to be performed.

For purposes of this subsection (37):

(x) Additional consideration is not nominal if

(i) when the option to renew the lease is granted to the lessee the rent is stated to be the fair market rent for the use of the goods for the term of the renewal determined at the time the option is to be performed, or

(ii) when the option to become the owner of the goods is granted to the lessee the price is stated to be the fair market value of the goods determined at the time the option is to be performed. Additional consideration is nominal if it is less than the lessee's reasonably predictable cost of performing under the lease agreement if the option is not exercised;

(y) "Reasonably predictable" and "remaining economic life of the goods" are to be determined with reference to the facts and circumstances at the time the transaction is entered into; and

(z) "Present value" means the amount as of a date certain of one or more sums payable in the future, discounted to the date certain. The discount is determined by the interest rate specified by the parties if the rate is not manifestly unreasonable at the time the transaction is entered into; otherwise, the discount is determined by a commercially reasonable rate that takes into account the facts and circumstances of each case at the time the transaction was entered into.

U.C.C. § 1-201(37).

51. Assume that the company in need of a piece of equipment having a cash price of $100,000 leases it for a 10 year term, with monthly rental payments of $1100. As before, the lessee defaults at the end of five years. If the equipment that is the subject of our lease is expected to have a fair market value of, say, $20,000 at the end of the lease, and if the lessee must pay that amount to keep the equipment, then our lease is likely to pass muster as a true lease.

Cf. Fogel, *Executory Contracts and Unexpired Leases in the Bankruptcy Code*, 64 MINN. L. REV. 341, 375 n.144 (1980) (in a true lease, the title has value at the end of the term).

who repossessed his collateral, but failed to complete the sale before bankruptcy was filed.[52] If lease termination was accomplished before filing, bankruptcy law assumes that nothing remains upon which bankruptcy can work—the debtor has no rights in the equipment and the equipment is not property of the estate.[53] Similarly, if the lessor has given notice that triggers the running of a termination period, the lease ends when that period expires even though a bankruptcy petition was filed meanwhile.[54] The trustee has no power to require turnover of the equipment by the lessor as the trustee may be able to do with the secured party.[55] One of the most striking differences between the bankruptcy treatment of these two transactions, therefore, is the extent of the trustee's power to reach out and stop the nonbankrupt party's exercise of his state law rights, in effect, to opt out of the bankruptcy system.[56] Given these rules surrounding prebankruptcy

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52. *See supra* note 28 and accompanying text.

53. Vanderpark Properties, Inc. v. Buchbinder (*In re* Windmill Farms, Inc.), 841 F.2d 1467 (9th Cir. 1988); *In re* LJP, Inc., 22 Bankr. 556 (Bankr. S.D. Fla. 1982) (prefiling termination may be based solely on insolvency); COLLIER, *supra* note 15, ¶ 365.02, at 365-16 & ¶ 365.04, at 365-37.

Note how characterization of a transaction as a lease or as a security interest determines what is property of the estate: if the transaction created a security interest and the transferor exercised his rights to terminate, the property may be recovered for the estate under the authority of United States v. Whiting Pools, Inc., 462 U.S. 198 (1983); if, on the other hand, the transaction created a lease, termination places the property beyond the trustee's reach.

As Dean Jackson and Professor Baird noted, this shades into questions of priority:

> We are asking what is property of the estate, but the underlying fight is between the *general creditors* and someone else, who asserts the property is "his." Recognizing the property right as belonging to someone else is really tantamount to saying that the person gets paid in full, and all the remaining creditors have that much less to split among themselves. Conversely, saying that the property is property of the estate and that the competing interest will *not* be recognized is tantamount to saying that the general creditors—probably *including* the defeated putative property claimant—get to use the asset to divide among themselves. Although labeled as a property of the estate issue, it is really a fight over who gets what—the priority of claims against that property, in other words.

D. BAIRD & T. JACKSON, TEACHER'S MANUAL: CASES, PROBLEMS AND MATERIALS ON BANKRUPTCY 79 (1985).

54. *See, e.g.*, Vanderpark Properties Inc. v. Buchbinder (*In re* Windmill Farms, Inc.), 841 F.2d 1467 (9th Cir. 1988) (if lease is terminated prebankruptcy, no lease exists for trustee to assume; if, however, state law allows lessee relief from forfeiture, lessee's trustee may reverse termination and assume lease); Moody v. Amoco Oil Co., 734 F.2d 1200 (7th Cir.), *cert. denied*, 469 U.S. 982 (1984); Kopelman v. Halvajian (*In re* Triangle Labs., Inc.), 663 F.2d 463 (3d Cir. 1981) (if terminated, bankruptcy filing does not resurrect lease); *In re* Boricua Motors Corp., 77 Bankr. 358 (Bankr. D.P.R. 1987); Consolidated Energy Corp. v. O'Brien (*In re* Compass Dev., Inc.), 55 Bankr. 260 (Bankr. D.N.J. 1985); Prudential Inv. Co. v. Physique Forum Gym, Inc. (*In re* Physique Forum Gym, Inc.), 27 Bankr. 691 (Bankr. D. Md. 1982).

55. See the discussion of United States v. Whiting Pools, Inc., 462 U.S. 198 (1983), *supra* note 28.

56. No reason may exist to quarrel with this result as far as prepetition termination is concerned. After all, one must determine what property, formerly leased by the debtor, is and is not property of the estate, just as one must know when the sale of repossessed collateral

termination, a debtor loses the possibility for a defensive filing with leases that would be available with security interests.

If the lessor did not terminate quickly enough, he will be subject to the automatic stay and will have to stay the course.[57] That course will probably not be very long if the debtor-lessee filed a Chapter 7 petition and the lease price is at or above the current market price. Under section 365(d)(1), the lease is deemed rejected unless the trustee assumed it within sixty days of the order for relief.[58] The trustee, therefore, will reject a lease that is of no

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has gone so far that filing bankruptcy cannot undo it.

Note that the property seized by the IRS in *Whiting Pools* had not yet been sold. Thus, the case is not authority for the proposition that property repossessed and sold can still be pulled back into the estate. On the contrary, the Court clearly suggested that turnover under § 542(a) would not be required after sale by the creditor:

> Of course, if a tax levy or seizure transfers to the IRS ownership of the property seized, § 542(a) may not apply. . . . Ownership of the property is transferred only when the property is sold to a bona fide purchaser at a tax sale. . . . Until such a sale takes place, the property remains the debtor's and thus is subject to the turnover requirement of § 542(a).

462 U.S. at 209, 211. In the analogous real property context, once a foreclosure sale is completed the debtor no longer has a property interest in the land. *In re* Burke, 10 Bankr. 163 (Bankr. E.D. Pa. 1981) (when bankruptcy is filed after a foreclosure sale and delivery of the sheriff's deed, debtor has no property interest, and the mortgagee who purchased at the sale is entitled to relief from the stay). Thus, property cannot be recovered for the estate under § 542(a) after completion of a foreclosure sale. The strategy at that point is to argue that the foreclosure sale constituted a fraudulent transfer, see Durrett v. Washington Nat'l Ins. Co., 621 F.2d 201 (5th Cir. 1980), or a preference, see *In re* Wheeler, 34 Bankr. 818 (Bankr. N.D. Ala. 1983).

If the stay were interpreted to prevent the running of a lease termination notice given prepetition and expiring postpetition, however, (just as it already prevents giving notice postpetition in a effort to trigger a termination) then the ability of lessors and secured parties to opt out of a bankruptcy proceeding would be equalized.

57. Under current law, that course ends upon expiration of the lease term, even if the trustee has assumed the lease. *In re* Boricua Motors Corp., 77 Bankr. 358 (Bankr. D.P.R. 1987). The secured party, on the other hand, must either win relief from the automatic stay or remain in the case for the duration. 11 U.S.C. § 362(c) (1988).

58. Subsection 365(d)(1) provides for automatic rejection of leases of residential real property and personal property in Chapter 7 cases:

> In a case under chapter 7 of this title, if the trustee does not assume or reject an executory contract or unexpired lease of residential real property or of personal property of the debtor within 60 days after the order for relief, or within such additional time as the court, for cause, within such 60-day period, fixes, then such contract or lease is deemed rejected.

Subsection 365(d)(4) provides a similar rule for leases of nonresidential real property regardless of the chapter under which bankruptcy was filed. An issue under both subsections is whether the court must act within the 60-day period or whether the court can act after that time if the trustee requested an extension within that period. Most of the courts holding that the motion for an extension must be granted within the 60-day period rely on the literal wording of the statute and the support for this result found in the legislative history, which reveals congressional concern with the negative impact on other tenants in a shopping center when premises are vacant for extended periods. *See, e.g.*, *In re* House of Deals of Broward, Inc., 67 Bankr. 23 (Bankr. E.D.N.Y. 1986). The weight of authority, however, now seems to fall on the side of those cases holding that the court need not act within the 60-day period, value to the estate,[59] just as the trustee abandons property fully encumbered by a security interest,[60] and the lessor will recover possession of the property as does the secured party. Even in rejection, the lessor with an above-market lease may be better off than a secured party because the lessor's claim may be based upon the above-market rate.[61] The secured party benefits from an above-market rate only when he is oversecured.[62]

The trustee, however, is likely to assume the lease if the equipment is currently renting for more than the lease price, because section 365(f)(2) permits assignment of the lease to a third party.[63] The trustee can thereby

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as long as the motion for an extension was timely filed and cause exists for granting it. *See, e.g., In re* Southwest Aircraft Servs., Inc., 831 F.2d 848 (9th Cir. 1987), *cert. denied sub nom.* Long Beach v. Southwest Aircraft Servs., Inc., 487 U.S. 1206 (1988).

59. The lease will have no value to the estate if similar equipment can be leased elsewhere for less than the monthly amount called for by the lease. The lessor's unsecured claim, which arises upon rejection, will not be paid in full by an insolvent estate, and some portion of the amount saved will be shared by the other unsecured creditors. Rejection, therefore, "provides a way of *equalizing* things among creditors when the liability represented by the contract exceeds the value of the asset represented by a contract." T. JACKSON, *supra* note 14, at 109.

Rejection is generally governed by the business judgment standard. National Labor Relations Bd. v. Bildisco & Bildisco, 465 U.S. 513, 523 (1984); Lubrizol Enters., Inc. v. Richmond Metal Finishers, Inc. (*In re* Richmond Metal Finishers, Inc.), 756 F.2d 1043 (4th Cir. 1985), *cert. denied sub nom.* Lubrizol Enter., Inc. v. Canfield, 475 U.S. 1057 (1986).

60. *See supra* note 24 and accompanying text.

61. This is certainly true for real property lessors, since their claims equal the present value of rent under the lease less the present value of the current market rent. *Cf.* City Bank Farmers Trust Co. v. Irving Trust Co., 299 U.S. 433, 443 (1937); Third Nat'l Bank v. Winner Corp., 29 Bankr. 383 (M.D. Tenn. 1982). The claim is, of course, subject to the cap of 11 U.S.C. § 502(b)(6).

Damages allowed for rejected leases of personal property are governed by state law. For a discussion of the remedies provisions of Article 2A, see *supra* notes 37-43.

62. In that case, the claim is entitled to postpetition interest under 11 U.S.C. § 506(b). Interest will accrue at the contract rate only until the trustee sells the property, which should happen fairly quickly in a Chapter 7 case. The secured party will be paid his claim plus interest, and then he must reinvest at the lower market rate.

63. In order to assign, § 365(f)(2)(A) requires that the trustee first assume the lease in accordance with the requirements of § 365. Some protection for the lessor drawn into his lessee's bankruptcy is found in the requirements surrounding assumption, see text *infra* at notes 79-85, and in the additional requirement that "adequate assurance of future performance by the assignee" be provided. 11 U.S.C. § 365(f)(2)(B) (1988). For a discussion of adequate assurance in the context of assumption, see *infra* note 81. In addition to the factors mentioned there, adequate assurance in the context of assignment carries an additional drawback—the statute's use of passive voice leaves unclear whether adequate assurance must be provided by the trustee or the proposed assignee. Fogel, *supra* note 51, at 362.

Assignment is possible even though the lease includes an anti-assignment clause. 11 U.S.C. § 365(f)(1) (1988). In this respect, the Bankruptcy Code may have presaged nonbankruptcy cases such as Kendall v. Ernest Pestana, Inc., 40 Cal. 3d 488, 709 P.2d 837, 220 Cal. Rptr. 818 (1985), which held that traditional property rules allowing lessors to prohibit alienation of leaseholds improperly inhibit alienability of land and conflict with contract law concepts of good faith and fair dealing that apply to leases. To the extent that this and other cases blur the line between property and contract concepts, they are consistent with the thesis of this Article that functional equivalence should replace distinctions based on form.

Finally, assignment relieves the bankruptcy estate of liability for any future breach by the assignee. 11 U.S.C. § 365(k) (1988).

capture for the estate the difference between the current price and the lease's below-market price, and the lessor will be stuck with the now disadvantageous bargain made with the debtor.[64] Thus, a lessor whose lessee files a Chapter 7 petition will either face a fairly prompt rejection of the lease (in which case the lessor has a claim against the estate for the breach[65]) or continued performance of the original lease terms by an assignee.

A major difference between bankruptcy's treatment of lessors and secured parties, therefore, is that, at least in Chapter 7,[66] leases are out of the bankruptcy estate unless the trustee takes affirmative steps to keep them in.[67] Secured arrangements, on the other hand, remain in the estate unless affirmatively excluded through abandonment.

The lessor faces substantially similar possibilities if the debtor files a Chapter 11 petition and the equipment is not needed for reorganization or the lease is not of value to the estate. As before, the debtor-in-possession will either reject the lease or assume and assign it, thereby capturing for the estate whatever market value the lease reflects.[68] The major difference lies in the lack of a provision like section 365(d)(1), which provides for

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64. A lessor is stuck with disadvantageous bargains outside of bankruptcy as well. The bargain with which the lessor is stuck in bankruptcy is not entirely identical to his original bargain with the debtor, however, because bankruptcy disregards ipso facto clauses, 11 U.S.C. § 365(b)(2), and may impose substituted performance upon the lessor unless the lease falls within the narrow exceptions in 11 U.S.C. § 365(c). Professor Nimmer has discussed the lessor's interest in the identity of the lessee. Nimmer, *Executory Contracts in Bankruptcy: Protecting the Fundamental Terms of the Bargain*, 54 U. Colo. L. Rev. 507, 533-38 (1983).

In any event, only the term of the lease can be assigned under § 365; the lessor's interest in the residual is unaffected.

65. The claim will be unsecured. Under our facts, *supra* note 51, the lessor has a claim for five years of rent at $1200 per month, for a total of $72,000, but he must mitigate by attempting to re-lease or sell the equipment. *See* Kothe v. Taylor Trust, 280 U.S. 224 (1930) (holding that a lease provision stipulating that damages will equal the total rent reserved for the remaining term is a penalty and will not be enforced); *see also* City Bank Co. v. Irving Trust Co., 299 U.S. 433, 443 (1937):

> The amount of the landlord's claim for the loss of his lease necessarily is the difference between the rental value of the remainder of the term and the rent reserved, both discounted to present worth. This, we have said, is a method of liquidation familiar and fair. It was the method adopted under § 77B in *Kuehner v. Irving Trust Co.*, 85 F. (2d) 35, the judgment in which is this day affirmed [299 U.S. 445].

Note also that the cap on a lessor's claim mandated by 11 U.S.C. § 502(b)(6) applies only to leases of real property.

66. In Chapter 11, a lease that is neither assumed nor rejected "rides through" bankruptcy and is binding on the postdischarge debtor. National Labor Relations Bd. v. Bildisco & Bildisco, 465 U.S. 513, 546 n.12 (1984) (Brennan, J., concurring in part and dissenting in part). In Chapter 11, therefore, an equipment lease is not rejected unless affirmative steps are taken to reject it. Collier, *supra* note 15, ¶ 365.03[2], at 365-31 (§ 365(d)(4) provides a different rule for leases of nonresidential real property).

67. This is accomplished by automatic rejection of a lease 60 days after the filing of a Chapter 7 petition, and by the requirement that the court approve assumption or rejection. 11 U.S.C. § 365(d)(1) & (a) (1988).

68. See the discussion of assignment, *supra* note 63.

automatic rejection within sixty days in Chapter 7 cases.[69] In a Chapter 11 case, the decision to assume or reject can be made at any time before confirmation of the plan, unless the lessor successfully compels an earlier decision.[70] The lessor whose lessee files under Chapter 11 may face a prospect of much greater delay,[71] therefore, than he would usually face in Chapter 7, even in a case in which the leased equipment is not going to be used by the reorganizing debtor.[72]

The debtor-in-possession may not be prepared to decide quickly whether to assume or reject, either because the equipment's importance to a suc-

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69. *See supra* note 58.

70. Section 365(d)(2) provides:

> In a case under chapter 9, 11, 12, or 13 of this title, the trustee may assume or reject an executory contract or unexpired lease of residential real property or of personal property of the debtor at any time before the confirmation of a plan but the court, on request of any party to such contract or lease, may order the trustee to determine within a specified period of time whether to assume or reject such contract or lease.

11 U.S.C. § 365(d)(2) (1988).

Cases interpreting § 365(d)(2) hold that the trustee has a reasonable time in which to decide to assume or reject, even when the nondebtor seeks to compel a decision before the time of confirmation. *See, e.g.*, *In re* Whitcomb & Keller Mortgage Co., Inc., 715 F.2d 375 (7th Cir. 1983) (bankruptcy court did not abuse its discretion in refusing to specify a time in which debtor had to assume or reject an executory contract for essential computer services when the debtor paid for all postpetition services and the parties specified that the nondebtor's lien would attach to proceeds from the sale of debtor's assets); Theatre Holding Corp. v. Mauro, 681 F.2d 102 (2d Cir. 1982) (finding no need to consider whether the bankruptcy court abused its discretion in allowing the debtor-in-possession only 30 days to assume or reject, when one year had passed since bankruptcy was filed and the debtor still was not close to formulating a plan); *In re* The Inn at Longshore, Inc., 32 Bankr. 942 (Bankr. D. Conn. 1983) (giving the debtor additional time to decide whether to assume or reject would be inequitable when one and a half years have passed since filing and the debtor is unable to provide the levels of compensation required to assume under § 365 or use the property under § 363); Dallas-Ft. Worth Regional Airport Bd. v. Braniff Airways, Inc., 26 Bankr. 628 (N.D. Tex. 1982) (bankruptcy court did not abuse its discretion in refusing to specify a time in which the debtor had to assume or reject because the lessor was adequately protected by receipt of full rental payments; setting a time limit two months after filing in a complex case would be unreasonable); New England Carpet Co. v. Connecticut Gen. Life Ins. Co., 18 Bankr. 514 (Bankr. D. Vt. 1982) (making the nondebtor wait until the confirmation hearing on debtor's plan for the decision to assume or reject is not unreasonable when the hearing will be held within six weeks to two months).

71. Reorganizations can go on for months, or even years, before a plan is confirmed. Johns-Manville Corporation, for example, filed bankruptcy in 1982; the order confirming its plan was upheld on appeal six years later. Kane v. Johns-Manville Corp., 843 F.2d 636 (2d Cir. 1988).

The equipment lessor is not completely without resources in the meanwhile, however, since § 365(d)(2) permits him to request that the court order the trustee to make a decision more quickly than that. Cases indicating how much leeway the trustee will be given by the courts are discussed *supra* note 70. Section 365(d)(2) is of no assistance to the lessor of commercial real estate. *In re* Musikahn Corp., 57 Bankr. 942 (Bankr. E.D.N.Y. 1986).

72. Since only the remaining term is property of the estate, the lessor faces this delay only until the lease term expires of its own accord or as a result of the running of a notice period triggered prebankruptcy. *See supra* note 57.

cessful reorganization is unclear or because of ongoing efforts to locate an assignee. The debtor-in-possession can keep and use the equipment during the postfiling, predecision period, despite the risk this use presents to the lessor, and compensate the lessor for this use at the current market rate.[73] Granted, that may not be as favorable as the lease rate, but it is certainly more than the secured creditor is entitled to receive in equivalent circumstances. The lessor also enjoys administrative expense priority for this compensation[74] and may be entitled to adequate protection in addition.[75]

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73. The prevailing rule is that the nondebtor is entitled to compensation for the reasonable value of property used by the debtor after filing and before the decision to assume or reject. National Labor Relations Bd. v. Bildisco & Bildisco, 465 U.S. 513, 531 (1984) ("If the debtor-in-possession elects to continue to receive benefits from the other party to an executory contract pending a decision to reject or assume the contract, the debtor-in-possession is obligated to pay for the reasonable value of those services, which, depending on the circumstances of a particular contract, may be what is specified in the contract.") (citations omitted); *In re* Pickens-Bond Constr. Co., 83 Bankr. 581 (Bankr. E.D. Ark. 1988); COLLIER, *supra* note 15, ¶ 365.03[3], at 365-32. Another line of cases holds that the lessor is entitled to compensation for the reasonable value of leased goods even though the estate enjoyed no benefit because the debtor did not use the goods after filing and before rejecting the lease and returning the goods. *See, e.g., In re* Energy Resources Co., Inc., 47 Bankr. 337 (Bankr. D. Mass. 1985); *In re* Fred Sanders Co., 22 Bankr. 902 (Bankr. E.D. Mich. 1982).

74. *In re* Subscription Television of Greater Atlanta, 789 F.2d 1530 (11th Cir. 1986); Memphis-Shelby County Airport Auth. v. Braniff Airways, Inc. (*In re* Braniff Airways, Inc.), 783 F.2d 1283 (5th Cir. 1986); *In re* Western Monetary Consultants, 100 Bankr. 545 (Bankr. D. Colo. 1989).

75. An unresolved issue is whether the lessor's exclusive remedial provision is § 365(d)(2) or whether the lessor may also seek, in the alternative, relief from the automatic stay under § 362(d) or adequate protection under § 363. Collier's asserts that "section 362(a)(3) applies to leasehold estates of the debtor and, hence *requires the lessor to seek relief under section 362(d).*" COLLIER, *supra* note 15, ¶ 365.04, at 365-38 (emphasis added). Professor Ayer found it anomolous that, when the nonbankrupt party wants to get the property back and the trustee wants to keep it, both lessors and secured parties can seek relief from the automatic stay under § 362(d), but that the lessor has the added alternative of forcing the trustee to assume or reject under § 365. He concluded, however, that a lessor "presumably" may proceed under § 362, thus having "two relatively parallel courses of action" when the trustee is disinclined to returned the leased property. Ayer, *supra* note 34, at 693. Similarly, Fogel argued that a lessor whose lease has not yet been assumed or rejected is entitled to adequate protection of the value of the leased goods to the extent that use of the goods during this period decreases their value. Fogel, *supra* note 51, at 372-75.

Professor Bordewieck, on the other hand, believed that a lessor is not entitled to seek relief from the automatic stay under § 362(d) because: 1) an adequate protection order would "effectively permit the lessor to enforce the lease prior to its assumption"; 2) legislative history clearly indicates that adequate protection was intended to benefit only secured parties; 3) to give adequate protection to a pre-assumption lessor's unenforceable contractual right would be inconsistent with the treatment of unsecured creditors, who are not entitled to adequate protection; and 4) an adequate protection order at the contract rate would be inconsistent with the principle that the lessor is entitled to compensation for use of his property at a "reasonable value." Bordewieck, *The Postpetition, Pre-Rejection, Pre-Assumption Status of an Executory Contract*, 59 AM. BANKR. L.J. 197, 213-16 (1985). He also argued that the lessor is not entitled to adequate protection payments under § 363(e) because that remedy is available only to secured creditors and because an unassumed lease is unenforceable between the parties and, thus, cannot be the basis for a right to payments. *Id.* at 217; *see also* Jones, *The Automatic*

Because equipment will probably be needed to reorganize, the debtor-in-possession can be expected to assume the lease and retain it.[76] It is here

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Stay and the Creditor Who Has Leased Consumer Goods, 88 COM. L.J. 134 (1983).

Although the courts are split, the prevailing view is that a lessor is entitled only to administrative rent for property the trustee uses pending the decision to assume or reject; the lessor is not entitled to adequate protection for the equipment's value during that period. *See, e.g.*, *In re* Cafe Partners/Washington 1983, 81 Bankr. 175 (Bankr. D.D.C. 1988); IFG Leasing Co. v. Christiansen Hatch Farms, Inc., 56 Bankr. 237 (D. Minn. 1985); *In re* Sweetwater, 40 Bankr. 733 (Bankr. D. Utah 1984), *aff'd*, 57 Bankr. 748 (D. Utah 1985).

One of the recent cases on this issue is one of the least satisfactory. The court in *In re* Reice, 88 Bankr. 676 (Bankr. E.D. Pa. 1988), held that a lessor of laundromat equipment was not limited to forcing assumption or rejection of the lease, but could also seek adequate protection from the Chapter 13 debtor. The case is unsatisfactory because the court seemed confused about the nature of the moving party's interest. The opinion states that "[t]he only *lien* of which we are aware is movant's interest in the equipment," *id.* at 679 (emphasis added), and quotes testimony given by movant's representative under questioning by debtor's attorney:

> Q. I see. You had a UCC 1 [Article 9 financing statement] on file with respect to this equipment[.]
>
> A. Yes[.]
>
> Q. Did you have any security agreement for the UCC 1?
>
> A. It's tied to the lease and it states it right on the UCC that it's only for filing and not intended as a security agreement.

Id. It appears from this testimony that movant was trying to establish that its interest was a true lease, not a security interest, and that its filing was precautionary under U.C.C. § 9-408. The court, however, missed the point: "We are troubled by the failure to describe movant's *security interest* more accurately. The parties do not appear to dispute, however, *that movant has a security interest* sufficient to invoke adequate protection concerns." *Id.* at 697 n.6 (emphasis added).

Even when the court was attempting to state the issue clearly, it apparently did not know whether the interest held by movant was a lease or a security interest:

> The controversial question shaping our decision is whether the language in 11 U.S.C. § 363 ('. . . entity that has an interest in property used, sold or leased . . .') covers a *lessor* of personal property in a chapter 13 during the period prior to the debtor's assumption or rejection of the unexpired lease, or whether the protections of § 362 are available only to secured parties.[9] Phrased on a more practical level, the question is whether a secured creditor has a constitutionally guaranteed right to have the value of its collateral protected.

Id. at 681. Footnote 9 further reveals the court's confusion: "We need not reach the question of whether special leases, such as leases with purchase options, assume enough of a secured or quasi-secured status to be entitled to § 362 protection. *The only discussion in this record of a possible security interest is garbled and not probative on the true nature of this lease.*" *Id.* at 681 n.9 (emphasis added). Given this confusion in the court's understanding, the case is poor authority for its apparent holding—namely, that a lessor whose lease has not yet been assumed or rejected is entitled to seek relief from the automatic stay under § 362 and is entitled to adequate protection under § 363 if relief is denied and debtor continues to use the leased property.

76. This is true if the lease is below market; it is also true if the lease is above market or close enough to the market rate that the transaction costs of finding another lessor make assumption and retention less expensive.

Assumption requires court approval. *In re* Whitcomb & Keller Mortgage Co., Inc., 715 F.2d 375 (7th Cir. 1983); *In re* Treat Fitness Center, Inc., 60 Bankr. 878 (Bankr. 9th Cir. 1986); *In re* Kelly Lyn Franchise Co., Inc., 26 Bankr. 441 (Bankr. M.D. Tenn. 1983).

that the most dramatic differences between bankruptcy's treatment of the secured party and the lessor are apparent[77] because assumption subjects the estate to substantially greater obligations to the lessor than to the secured party.[78] To assume the lease, the debtor-in-possession must: cure pre-existing defaults or provide adequate assurance that defaults will be promptly cured;[79] compensate the nondebtor for any pecuniary losses or provide adequate assurance of prompt compensation for such losses;[80] give adequate assurance of future performance according to the lease terms;[81] assume the lease *cum onere*—with all its benefits and burdens[82]—giving the lessor "the full benefit

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77. Oddly, § 365 and its predecessors are explained as part of the trustee's power to abandon burdensome property, COLLIER, *supra* note 15, ¶ 365.01[1], at 365-10; Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 MINN. L. REV. 439, 439 (1973), but "rejection is simply tantamount to a breach of the contract permitted under nonbankruptcy law." T. JACKSON, *supra* note 14, at 108. It is *assumption*, rather than rejection, that carries the most remarkable consequences. *See* Andrew, *supra* note 6, at 890.

78. While assumption creates the estate's greatest obligations toward lessors, in other cases § 365 provides for significant obligations upon rejection. If the trustee rejects an executory contract for the sale of real property, for example, a nondebtor purchaser in possession is given significant rights under § 365(i).

79. 11 U.S.C. § 365(b)(1)(A) (1988). This is even better than secured status for prepetition defaults, because arrearages may be paid immediately rather than be paid out under a plan, on a delayed basis.

Section 365 is not the only Code provision under which cure can be effected; § 108(b) provides that if nonbankruptcy law fixes a period within which a default can be cured, the trustee has until the later of the end of that period or 60 days after the order for relief to accomplish it. Professor Julis asserts that the trustee's "power" to cure defaults is greater under § 365 than under § 108(b), because the former allows adequate assurance of cure, rather than immediate cure, and a longer time period in which to accomplish it. Julis, *Classifying Rights and Interests Under the Bankruptcy Code*, 55 AM. BANKR. L.J. 223, 247 (1981).

80. 11 U.S.C. § 365(b)(1)(B) (1988).

81. 11 U.S.C. § 365(b)(1) (1988). Adequate assurance is not perfect from the lessor's viewpoint, of course. First, adequate assurance is not "a conceptual synonym for strict performance," Simpson, *Leases and the Bankruptcy Code: Tempering the Rigors of Strict Performance*, 38 BUS. LAW. 61, 73 (1982), and it does not mean that an absolute guarantee of performance must be given. *In re* Natco Indus., 54 Bankr. 436, 440 (Bankr. S.D.N.Y. 1985); *In re* Luce Indus., Inc., 8 Bankr. 100 (Bankr. S.D.N.Y. 1980). Second, adequate assurance is required only if default has occurred. 11 U.S.C. § 365(b)(1) (1988); *In re* Ridgewood Sacramento, Inc., 20 Bankr. 443 (Bankr. E.D. Cal. 1982). Finally, these provisions may be satisfied by methods other than immediate cash payments. COLLIER, *supra* note 15, ¶ 365.04[1], at 365-38.

Despite all of this, the lessor facing assignment is still better off than the secured party to whom analogous protection is not extended under § 363 when the trustee wants to use equipment constituting his collateral. The secured party is compensated for any depreciation, but defaults need not be cured and compensation for the lost opportunity to repossess, sell, and reinvest the proceeds cannot be claimed. United Sav. Ass'n of Texas v. Timbers of Inwood Forest Assocs., Inc., 484 U.S. 365 (1988). The protections given a lessor are also greater than those extended by § 363(f) to a secured party whose collateral is sold by the trustee.

82. Although the Code is not explicit on this point, it is clearly the rule. National Labor Relations Bd. v. Bildisco & Bildisco, 465 U.S. 513, 531 (1984); Richmond Leasing Co. v. Capital Bank, N.A., 762 F.2d 1303 (5th Cir. 1985). Property subject to a security interest, on the other hand, can be abandoned in part.

of his bargain''[83] and preventing the debtor-in-possession from altering the terms of the lessor's deal through a cram-down;[84] and treat both of these sets of obligations as administrative expense priorities.[85] Requiring the debtor-in-possession to comply precisely with the terms of an assumed lease allows the lessor to avoid valuation determinations suffered by secured parties that may result in lower valuations of collateral than anticipated[86] and effectively allows the lessor's rights to trump all others.[87]

Of course, the estate is not worse off by assuming rather than rejecting the lease; a lease will not be assumed in the first place unless the asset it represents outweighs the burden of the liabilities it carries.[88] Nevertheless, section 365 strikes a balance of bankruptcy risks differently than do the provisions governing the rights of secured parties. The treatment accorded lessors may, in fact, be more favorable[89] than that accorded any other type of party or class of claims in bankruptcy.[90]

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83. SENATE REPORT, *supra* note 32, at 5845. Despite this brave language, some but not all economic interests are protected in bankruptcy, even when a lessor is involved. The unenforceability of ipso facto clauses under § 365(b)(2) & (e), for example, means that a lessor's interest in ditching a losing contract is not protected.

84. Under § 1123(b)(2), plan provisions for the assumption, rejection, or assignment of unexpired leases not previously dealt with are subject to the requirements of § 365. As the text indicates, those requirements include substantial protections for the lessor.

85. See sources cited *supra* note 74.

The secured party, on the other hand, is entitled to the interest stipulated in the security agreement only if he is oversecured. 11 U.S.C. § 506(b) (1988).

86. *See supra* note 20.

87. A secured party is susceptible to the super-priority that a postpetition lender can obtain under § 364(d)(1). Additionally, a secured party may have to accept a replacement lien in property other than his original collateral. 11 U.S.C. § 361(2) (1988). A lessor is immune to both of these threats.

88. Dean Jackson pointed out that executory contracts and leases are simultaneously assets and liabilities—the nondebtor's unperformed obligation is an asset of the estate, while the debtor's unperformed obligation is a liability. T. JACKSON, *supra* note 14, at 105-08.

89. It is not invariably true that lessors fare better than secured parties. Occasionally, the nondebtor prefers that his agreement with the debtor be categorized as a security interest rather than a lease. In *In re* Holywell Corp., 51 Bankr. 56 (Bankr. S.D. Fla. 1985), for example, the nondebtor bank stood to gain $10 million more from a finding that its lease of hotel fixtures and equipment was not a true lease than it would get if it were. Although the court did not elaborate, this result apparently followed because the bank had not provided the funds to purchase the collateral.

90. This assertion requires two caveats: first, nondebtor parties to executory contracts, who are included with lessors under § 365, also enjoy this favorable treatment; and second, lessors of real estate whose claims are capped by 11 U.S.C. § 502(b)(6) may not view their treatment in bankruptcy so fondly.

Arguably, this favorable treatment is not as burdensome to the bankruptcy estate as appears at first blush, since the debtor-in-possession will assume only those leases under which the asset the lease represents outweighs the liability the lease imposes. That fact alone, however, does not justify devoting estate assets to the full compensation of lessors when other parties are expected to absorb their pro rata share of losses flowing from the insolvency, and ensuing bankruptcy, of their common debtor.

This is not to suggest that lessors suffer no negative impact at all from the bankruptcy

Giving the lessor power to compel compliance with each and every term of the lease agreement (when the debtor-in-possession needs continued use of the leased equipment) is akin to giving the lessor a right of specific performance that constitutes a species of opt-out behavior.[91] Recognition of the lessor's in rem rights may burden a reorganization[92] that is intended to preserve a company's going concern value for the benefit of everyone

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of their lessees, however. In the case of a below-market lease, which is the most likely lease to be assumed by the debtor-lessee, a lessor loses the difference between the lease rate and the market rate that could have been captured by the lessor outside of bankruptcy upon termination of the lease. Jackson & Scott, *On the Nature of Bankruptcy: An Essay on Bankruptcy Sharing and the Creditors' Bargain*, 75 VA. L. REV. 155, 186-87 (1989). Moreover, lessors are compensated at the prevailing market rate, rather than a higher contract rate, for use of their property pending the decision to assume or reject, *supra* note 73, and lessors may be forced to accept substituted performance from an assignee. 11 U.S.C. § 365(b)(1)(B) (1988). Finally, as Professor Nimmer noted, assumption is not performance; rather, assumption merely constitutes another promise to perform, which is reduced in value by the weakened financial circumstances that are virtually always the *sine qua non* of bankruptcy and by the prospect of performance by a different legal entity. Nimmer, *supra* note 64, at 532-38.

91. Creditors having rights to specific performance under state law do not have similar powers in relation to the trustee in bankruptcy. If state law allows an alternative right to payment, the creditor holds a claim in bankruptcy that is subject to discharge:

> Section 101(4)(B) . . . is intended to cause the liquidation or estimation of contingent rights of payment for which there may be an alternative equitable remedy with the result that the equitable remedy will be susceptible to being discharged in bankruptcy. For example, in some States, a judgment for specific performance may be satisfied by an alternative right to payment, in the event performance is refused; in that event, the creditor entitled to specific performance would have a "claim" for purposes of a proceeding under title 11.

124 CONG. REC. H11,090 (Sept. 28, 1978) (statement of Rep. Edwards); 124 CONG. REC. S17,406 (Oct. 6, 1978) (statement of Sen. DeConcini). Even in the absence of such an alternative right under state law, a creditor cannot enforce a right to specific performance against the bankruptcy estate. Lubrizol Enters., Inc. v. Richmond Metal Finishers, Inc., 756 F.2d 1043, 1048 (4th Cir. 1985), *cert. denied sub nom.* Lubrizol Enter., Inc. v. Canfield, 475 U.S. 1057 (1986) ("Allowing specific performance would obviously undercut the core purpose of rejection under § 365(a), and that consequence therefore cannot be read into congressional intent.") Apparently to the contrary, Proyectos Electronicos, S.A. v. Alper, 37 Bankr. 931 (E.D. Pa. 1983), held that a buyer of equipment fully paid for is entitled to specific performance of the sale contract from the trustee; the goods involved in that case, however, were not necessary for an effective reorganization.

In specific instances the statute itself recognizes rights akin to specific performance, as Professor Nimmer pointed out. Nimmer, *supra* note 64, at 520. Subsection 365(h), making the trustee's right to reject a real estate lease subject to the nonbankrupt lessee's right to remain in possession, and subsection 365(i), limiting the trustee's right to reject contracts for the sale of real property when the nonbankrupt purchaser is in possession, "involve a form of specific performance . . . premised on a congressional judgment concerning the desirability of protecting the specific types of parties and interests involved." *Id.*

Professor Nimmer argued in favor of bankruptcy recognition, at least in a limited way, of rights to specific performance held by nonbankrupt parties. Nimmer, *supra* note 64, at 529-30.

92. Although the lease will not be assumed in the first instance unless its asset value is greater than its liability value, see *supra* note 88 and accompanying text, the elevated obligation owed lessors is more difficult for the estate to meet than the obligation owed lienors.

involved, but the burden serves solely to preserve the lessor's interests. Lienors are not treated in this way—their in rem rights are not recognized in bankruptcy because of the burden such recognition would place on the prospect of successful reorganization.

III. Justifications for Different Treatment

Rationality dictates that such dramatic differences in bankruptcy's treatment of lessors and secured parties be supported by distinctions, relevant to bankruptcy policy, between the two types of claimants. Examination reveals, however, that nothing in the nature of the rights of lessors as opposed to secured parties, whether those rights are formal, economic, or constitutional, necessitates or justifies this differential treatment.

A. *Contract and Property Rights*

Part of the historical explanation for development of different bankruptcy treatment for leases and security interests lies in the distinction between property rights and contract rights. Efforts to distinguish the treatment accorded lessors from that accorded secured parties, however, cannot succeed on the ground that the former have property rights while the latter enjoy only contract rights.[93] First of all, such an argument requires overlooking the all-too-obvious fact that leases and security agreements are both contracts. Secondly, secured parties also are commonly said to have property rights.[94] Despite these property rights, secured parties receive

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93. The contract-property distinction has already been shown to provide an unconvincing basis for distinguishing the bankruptcy treatment accorded secured creditors from that accorded unsecured creditors. *See generally* 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, 989-95 (1983). *Cf.* Eisenberg, *The Undersecured Creditor in Reorganizations and the Nature of Security*, 38 VAND. L. REV. 931, 961-62 (1985).

94. *Hearings on H.R. 31 & 32 Before the Subcomm. on Civil & Constitutional Rights of the House Comm. on the Judiciary*, 94th Cong., 1st Sess., Part 1, 437-38 (statement of Patrick A. Murphy); *id.*, 2d Sess., Part 2, 1057 (statement of Walter Ray Phillips); *id.*, 2d Sess., Part 3, 1363 (statement of Alvin O. Wiese, Jr.) [hereinafter *Hearings*].

In fact, all of the parties involved in these transactions can be said to enjoy property rights, since the bankruptcy debtor, whether lessee or debtor under a security agreement, also has rights in the property transferred by that lease or security agreement. In discussing what interests of a debtor become part of the estate, the Code's legislative history states that "[t]he debtor's interest in property . . . includes 'title' to property, which is an interest, just as are a possessory interest, or leasehold interest." SENATE REPORT, *supra* note 32, at 5868; H.R. REP. No. 595, 95th Cong., 1st Sess. 367 (1977), *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS 5963, 6323 [hereinafter HOUSE REPORT].

Professor Ayer's opinion seems to be to the contrary. He asserted that the pattern of current law, albeit "untenable," demonstrates that "the mere lessee never rises to the dignity of a party with a 'property' interest, such as the interest of the debtor under a security agreement. Thus, the lessee is not accorded any special powers against the competing claimant." Ayer, *supra* note 34, at 696. His assertion should not be read to contradict the proposition that a lessee enjoys property rights in the leased equipment, however. The assertion was made protection in bankruptcy only to the extent of the value of their collateral; in rem rights in that collateral, provided under state law, are not protected.

Thus, it cannot be the case that the lessor has property rights while the secured party does not; rather, the argument, if it is to succeed at all, must be that the lease, although a type of contract, creates property rights not created by the security agreement—in other words, that attributes of the lessor's property rights are different in some significant way from attributes of the secured party's property rights.

Perhaps the most important of the formal incidents of property in this context is "title." Leases and security arrangements are often distinguished on this dimension alone[95]—the lessor retains title, but the secured party either conveys it at some point in the transaction[96] or never had it in the first place.[97] The presence of title in the lessor seems to account for the

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in the course of demonstrating that the lessee in bankruptcy is in a take-it-or-leave-it situation with regard to the lease, while the debtor under a security arrangement can rewrite the contract and, in some circumstances, altogether avoid the creditor's security interest in the goods that are the subject of the transaction. Clearly the lessee has a property interest in leased goods sufficient to draw the lease and the goods into the estate under § 541. The extent of the estate's claim is different in the two cases, of course, since a lease is property of the estate, under current law, only for the duration of the term. Moody v. Amoco Oil Co., 734 F.2d 1200, 1212 (7th Cir.), *cert. denied,* 469 U.S. 982 (1984). No similar restrictions benefit the secured party.

95. The possibility of using location of title as a screen for unrecorded interests in the debtor's property is another reason for rethinking the treatment of leases in bankruptcy as well as in other areas of the law:

> [U]nless it contains an option to purchase, a personal property lease by Brawn Bakery Co., Inc. of its bakery equipment from Bakery Equipment Mfg. Corporation will be treated under the Code as a "true" lease, altogether exempt from the notice filing requirements of Article 9. Lease financing is becoming increasingly common and voluminous, not only because of its commercial convenience and tax advantages in particular circumstances, but because it obviates the formalistic pitfalls of perfection imposed in secured transactions.
>
> How appropriate is it to make the requirement of notice filing turn upon the whereabouts of "title" to the equipment in question, particularly in view of the solemn rejection of that standard by Article 9 of the Code? As far as bankruptcy jurisprudence is concerned, the Bakery Equipment Mfg. Corporation lease may represent a clearer threat to the creditors of Brawn Bakery Co., Inc. than the formally insufficient financing statement filed by the Bank, since there is not so much as a requirement that an attempt even be made to provide constructive notice that Brawn Bakery Co., Inc. had no 'interest' in the equipment in its possession.

Hearings, Part 1, *supra* note 94, at 217-18 (statement of Conrad Cyr) (footnotes omitted). Although Judge Cyr was testifying in opposition to the strong arm clause, his argument supports the proposition, which others have also asserted, see, *e.g.*, Kripke, Book Review, 37 BUS. LAW. 723, 728 (1982) (reviewing EQUIPMENT LEASING—LEVERAGED LEASING, *supra* note 1 (2d ed.)), that leases should be subject to recording requirements similar to those found in Article 9. Obviously, the argument is beyond the scope of this Article.

96. *Hearings,* Part 3, *supra* note 94, at 1866 (statement of the American Assoc. of Equipment Lessors, Inc.). Under the pre-Article 9 "conditional sale," title did not pass until the debtor-purchaser completed all of the payments to the seller.

97. Under two types of security arrangements, the secured party may never have had formal title to the goods that are subject to the security interest. First, the secured party who

evolution of bankruptcy's treatment of leases,[98] yet the functional equivalence of the lessor's and secured party's interests has been noted in the context of property law.[99] In other areas of commercial law, title's place has slipped. In fact, the significance of bare legal title has steadily eroded over the years, ever since Karl Llewellyn began the process in the 1930s.[100] The Uniform Commercial Code has completed the erosion by virtually eliminating title's commercial significance. Under Article 2A, which governs leases, the location of title is neither determinative[101] nor immovable.[102] Title similarly determines little or nothing under Article 2,[103] which governs the

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lent money to enable the debtor to purchase goods from another will not have title despite the transaction's character as a purchase money security interest. Second, the secured party who lent on the basis of collateral already owned by the debtor will not have or take formal title at any point in the transaction.

98. "On common law theory, the lessor, since he has not parted with title, is entitled to full protection against the lessee's creditors and trustee in bankruptcy." 1 G. GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY § 3.6, at 76 (1965).

99. Professor Johnson argued, in the context of long-term leases of real property, that the substance (as opposed to the form) of a mortgage transaction creates interests in the mortgagee that are like those of a lessor:

> In effect, the mortgagee, the party who puts up the bulk of the purchase price (anywhere from 80 to 95% in the typical mortgage transaction), should be viewed as the true purchaser of the property—very much like an owner/lessor of property. At the instant title is transferred, who has the larger interest in the property, Bob Byar or Mortgagee Bank? Functionally, Mortgagee Bank becomes the grantor and Byar the grantee. Mortgagee Bank purchases the property and then instantaneously transfers it to Byar with the security interest, the mortgage, attached . . . in exchange for the stream of income represented by the monthly payments. That security interest and the right to foreclose are very similar to a reversionary interest. Although the reversionary interest retained by the mortgagee is slightly different than that retained by a lessor, I argue that the mortgagee's interest is reversionary in some respects and should be analyzed acccordingly.

Johnson, *Correctly Interpreting Long-Term Leases Pursuant to Modern Contract Law: Toward a Theory of Relational Leases*, 74 VA. L. REV. 751, 775 n.84 (1988).

100. *See, e.g.*, Llewellyn, *Through Title to Contract and a Bit Beyond*, 15 N.Y.U. L.Q. 159, 167 (1938).

101. Admittedly, Article 2A is a bit schizophrenic on this point. Comment (j) to § 2A-103, which discusses the definition of "lease" and the criteria for determining whether a particular lease is a true lease, states "a sale or a security interest is not a lease. *Since there is no passing of title, there is no sale.*" (Emphasis added). This sentence implies that the passing of title determines the characterization of the transaction, despite clear language to the contrary in section 2A-302. The latter states that "[e]xcept as otherwise provided in this Article, each provision of this Article applies whether the lessor or a third party has title to the goods, and whether the lessor, the lessee, or a third party has possession of the goods . . . ."

102. Under U.C.C. § 2A-305(2), a buyer in the ordinary course of business who purchases from a lessee who is a merchant dealing in goods of that kind, to whom the goods were entrusted, takes "all of the lessor's and lessee's rights to the goods." This provision serves to transfer the lessor's title to the buyer.

103. Section 2-401 of the U.C.C. provides that "[e]ach provision of this Article with regard to the rights, obligations and remedies of the seller, the buyer, purchasers or other third parties applies irrespective of title to the goods except where the provision refers to such

sale of goods. Article 9 discounts title as well,[104] and an effort to retain title "is limited in effect to a reservation of a 'security interest.'"[105] Thus, "title" is not a defense to competing claims in the context of Article 9, and the seller of goods on credit who retains formal title until the price is fully paid (a conditional sale) may lose his claim to the goods if he has not complied with the perfection requirements of Article 9 before a competing claimant comes along.[106] Furthermore, even certain sales transactions under which title is expected to pass are nonetheless security interests subject to the provisions of Article 9.[107]

Title's reign is not absolute in all areas of bankruptcy law either. The title wall has been breached in the historical development of bankruptcy law, as exemplified by evolution in the use of a secured party's collateral. Before 1978 such use was regarded as conversion,[108] but that did not prevent the 1978 Code from changing the rules to allow such use.[109] Bankruptcy continues to disregard title in at least three circumstances. First, bankruptcy has adopted Article 9's distinction between true leases and security leases, so the location of title is irrelevant in determining the category into which a particular lease falls for bankruptcy purposes as well as for Article 9 purposes.[110] Secondly, bankruptcy disregards title to achieve the policies

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title."

As under Article 2A, title can also be lost under Article 2 if goods entrusted to a merchant who deals in goods of that kind are purchased by a buyer in the ordinary course of business. U.C.C. § 2-403(2).

104. This provision of Article 9, unlike the equivalent provisions of Articles 2A and 2, is without exception: "Each provision of this Article with regard to rights, obligations and remedies applies whether title to collateral is in the secured party or in the debtor." U.C.C. § 9-202.

105. U.C.C. § 1-201(37).

106. More accurately, the conditional seller will be subordinate in priority to the competing claimant who has complied with perfection requirements. The competing claimant will enjoy the right to be paid first out of the proceeds of the goods and, if the goods are not worth enough to pay both claimants in full, the conditional seller will lose all claim to the goods or their proceeds. If the competitor is an existing claimant with an after-acquired property clause, the seller can only prevail if he complies with Article 9's rules for purchase money secured parties. U.C.C. § 9-312(3). In either event, having formal title will avail him nothing.

Similarly, conveyance of title will not necessarily preclude application of Article 9. Comment 4 to U.C.C. § 9-203 states that the definition of "security agreement" as "an agreement which creates or provides for a security interest," U.C.C. § 9-105(1)(l), "is not intended to reject, and does not reject, the deeply rooted doctrine that a bill of sale although absolute in form may be shown to have been in fact given as security."

107. Sales of accounts and chattel paper are subject to Article 9, U.C.C. § 9-102(1)(b). The chief distinction applicable to such transactions is found among the remedies—the debtor is entitled to any surplus and liable for any deficiency "only if the security agreement so provides." U.C.C. § 9-504(2).

108. Coogan, Broude & Glatt, *Comments on Some Reorganization Provisions of the Pending Bankruptcy Bills*, 30 Bus. Law. 1149, 1169 (1975).

109. *See* 11 U.S.C. § 363 (1988).

110. The legislative history clearly indicates that location of title is to be disregarded for this purpose:

behind the avoiding powers of preferences and fraudulent conveyances.[111]

Thirdly, bankruptcy has moved away from the supremacy of title in the context of a contract for deed—a device under which the seller retains title until fully paid and, upon the purchaser's default, gets the land back and keeps all amounts previously paid. In *In re Booth*,[112] the debtor had purchased land under a contract for deed. The sellers moved for an order under section 365(d)(2) requiring the debtor either to assume or reject the contract, but the debtor argued that section 365 was inapplicable. Thus, the issue in the case was whether the contract for deed was executory. The sellers would have been greatly benefited by a finding that it was executory, without regard to whether the debtor then assumed or rejected. If executory, section 365 would require that the debtor either assume (by making all missed payments or by giving adequate assurance that they would be paid, and complying with future obligations under the contract, including the obligation to make future payments on time) or reject (which would result in forfeiture of all previous payments and loss of any equity in the property).[113] If the contract was not executory, however, the seller would have a secured claim for the balance of the price; the debtor could pay it off under a plan that modified the seller's rights (for example, by reducing the amount of each installment, extending the term, and reducing the interest rate).[114]

The *Booth* court held that the contract for deed should be treated as a lien, rather than as an executory contract, for three reasons—such treatment enlarged the value of the estate,[115] furthered the rehabilitation of the debtor,[116] and adequately protected the interests of the sellers.[117]

Booth has been severely criticized for disregarding state created differences between a contract for deed and a secured sale[118] despite the fact that

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> Whether a "lease" is [a] true or bona fide lease or, in the alternative, a financing "lease" or a lease intended as security, depends upon the circumstances of each case. The distinction between a true lease and a financing transaction is based upon the economic substance of the transaction and not, for example, upon the locus of title, the form of the transaction or the fact that the transaction is denominated as a "lease."

SENATE REPORT, *supra* note 32, at 5850.

111. A transfer of property that meets the tests for a preference set out in § 547 can be recovered even though the transfer was in a form, such as a payment in cash, that vested title to the transferred property in the transferee. Similarly, a transfer found to constitute a fraudulent conveyance within § 548 is recoverable despite passage of title. *See, e.g.*, Durrett v. Washington Nat'l Ins. Co., 621 F.2d 201 (5th Cir. 1980).

112. 19 Bankr. 53 (Bankr. D. Utah 1982).

113. *In re* Booth, 19 Bankr. 53, 58 (Bankr. D. Utah 1982).

114. *Id.* at 60-61.

115. The estate was enlarged by preventing "forfeiture and the loss of equity." *Id.* at 58.

116. Treating the sellers as holders of a lien "allows more latitude in proposing a plan and thereby furthers the rehabilitation of the debtor." *Id.* at 61 (footnote omitted).

117. *Id.*

118. Dean Jackson is a leader of this criticism:

> *Booth* was not simply applying a different bankruptcy label and then using special

many states no longer adhere to the distinction between mortgage and contract for deed when to do so would exalt form over substance.[119] What *Booth* disregarded for bankruptcy purposes, more specifically, was *title* and one of the state law consequences of the location of title.[120] Despite progression of state commercial and leasing law beyond title as a factor that determines result, and despite bankruptcy's disregard of title in certain circumstances, title reigns supreme in the bankruptcy world of leasing.[121] *Booth*, however, is authority for the proposition that title need not determine consequences in bankruptcy any more than it does under the U.C.C.[122] To treat the lessor like a secured party, regardless of the technical location of title, therefore, is analogous to what some bankruptcy courts do with a contract for deed.

One must conclude from all of this that no difference between the formal property rights of a lessor and those of a secured party is significant enough to justify bankruptcy's radically different treatment of the interests

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> powers of section 365, but rather it was substantively recharacterizing the underlying property right from a contract for deed to a secured sale. . . . That the *Booth* court viewed section 365 as the justification for a property recharacterization and that many other judges concur suggest how far that section has strayed from bankruptcy's normative underpinnings as a collective debt-collection device and how it invites others to stray with it.

T. JACKSON, *supra* note 14, at 121; *see also* Andrew, *supra* note 6, at-893 n.174 ("[T]he [*Booth*] court's definitional approach, if taken seriously, suggests that a bankruptcy court can, on a discretionary, ad hoc basis, simply change or eliminate contract or property rights of third parties so as to best advantage the estate.").

119. *Booth*, 19 Bankr. at 58-59 n.9. For a brief discussion of this evolution, see Cribbet, *Concepts in Transition: The Search for a New Definition of Property*, 1986 U. ILL. L. REV. 1, 13-14.

120. The court said that "vendors have two rights under a contract for deed: the right to payment, which is not adequately protected, and the right to hold title as security, which is adequately protected." *Booth*, 19 Bankr. at 61 (footnote omitted). The sellers were left with the latter, but it gave them no greater protection than that enjoyed by a lienholder who transferred title to the buyer at the front end of their transaction.

121. Transfer of title also determines when the power to compel turnover under § 542 ends. *In re* Brown, 106 Bankr. 546 (Bankr. N.D. Ill. 1989).

Title has been defended as a way to distinguish claims that can be defeated from those that cannot. Boss, *Leases and Sales: Ne'er or Where Shall the Twain Meet?* 1983 ARIZ. ST. L.J. 357, 362 n.26. This is not altogether accurate, as the text shows, since many claims carrying title can be defeated both in and out of bankruptcy. To the extent it is accurate, however, it confuses a result with a reason. The question for consideration is why claims carrying title have been treated as indefeasible.

122. *Booth* has been both followed, *e.g.*, *In re* Fox, 83 Bankr. 290 (Bankr. E.D. Pa. 1988); *In re* Flores, 32 Bankr. 455 (Bankr. S.D. Tex. 1983), and rejected, *e.g.*, *In re* Speck, 798 F.2d 279 (8th Cir. 1986); Dahlke v. Doering, 94 Bankr. 569 (D. Minn. 1989); Shaw v. Dawson, 48 Bankr. 857 (D.N.M. 1985). *Compare* Terrell v. Albaugh (*In re* Terrell), 892 F.2d 469 (6th Cir. 1989) (declining to follow *Booth* and holding that a land sale contract is an executory contract because state law imposes material obligations on both parties), *with In re* Streets & Beard Farm Partnership, 882 F.2d 233 (7th Cir. 1989) (holding that vendor's obligation to deliver title upon completion of payments is not a significant enough legal obligation to render the installment land sale contract executory).

of those two parties. To suggest that lessors, therefore, be subjected to the same treatment as secured parties would not offend notions revolving around the concept of property. Such a change would parallel the loss of title permitted by the U.C.C.,[123] and would constitute another step down a road bankruptcy law has previously taken.

Of course, the lessor's formal property right—his "title"—also carries substantive rights. Thus, the substantive rights associated with leases and security interests must also be considered.

B. *Substantive Similarities and Differences*

Other writers have noted that leases are difficult to distinguish from security interests. Professor Kripke argued that no genuine distinction exists between a true lease and an installment purchase, and that both carry substantially similar substantive rights:

> The man from Mars, with a clear eye undistorted by training in law, accounting, or taxation, would find in the installment purchase a device by which the user of property acquired the right to use it in return for installment payments which cover the costs advanced by someone else (the secured party or lender) plus a charge for the use of money. If the man from Mars looked at the long-term lease with the same clear eye, he would find precisely the same thing except that installment payments by the user are limited, and at the end of a limited contracted period of use, the remaining use life of the property belongs either to the supplier of funds or to the passive third-party lessor who occupies that position to receive the benefit of the tax manna. The similarities are so great that the differences should fade into insignificance.[124]

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123. *See supra* notes 102-03.

124. Kripke, *supra* note 95, at 727. For a response to Professor Kripke's arguments, see Coogan, *Is There a Difference Between a Long-Term Lease and an Installment Sale of Personal Property?*, 56 N.Y.U. L. Rev. 1036 (1981). Mr. Coogan objected to eliminating the U.C.C.'s distinction between true leases and security leases primarily because he had

> long taken the position that the remedy provisions of the UCC do not fit a default on a true lease. What might be thought of as the collateral—the equipment—belongs to the lessor, not the lessee. It makes no sense to tell the lessor to sell his own property in order to collect the lessee's obligation to him. Homer [Kripke] says my analysis is wrong: that the lessor is not required to sell the equipment itself, but only the balance of the lease term, which is owned by the lessee (although most lessors, he says, would not be adverse also to selling the residual in the equipment, which they do own). Once the remaining lease term is sold, the proceeds could be credited against the lessee's deficiency.
>
> Assuming Homer is right, is it not true that the lease probably will have been terminated, or at least does not the lessor have the right to terminate? Under the UCC and the common law of leasing, once the lease is terminated the lessee has no right, absent a bankruptcy proceeding, to reinstate the lease even by paying accrued rent. . . .
>
> Even if the lease is not terminated or is reinstated, how saleable is a right to

Although Professor Kripke's point was that lease transactions should be subjected to filing requirements similar to those imposed by Article 9 on security interests,[125] his insight into the similarity of leases and security interests[126] is also relevant to whether bankruptcy should treat the two transactions so differently. Professor Ayer made the point more directly. He also noted that leases are difficult, if not impossible, to distinguish from security interests and concluded that bankruptcy's disparate treatment of the two types of transactions cannot be justified.[127]

> use equipment for a limited time? If the lessor sells the equipment, how can we determine what portion of the sale proceeds is attributable to the remaining lease term and what portion was paid for the residual? Perhaps, as Homer suggests, we could work out a statutory formula that would determine such questions. Such a formula, however, does not eliminate the need to distinguish between the very different rights possessed by a lessee under a true lease and by a debtor under a security agreement.

Coogan, *supra*, at 1048-49 (footnotes omitted).

125. Kripke, *supra* note 95, at 728.

126. Facts regarding the useful life of the equipment upon expiration of the term, and lease terms regarding purchase options, termination options, rights to a deficiency claim, sharing of increases in property value, sharing in profits, and the like, make a lease particularly difficult to distinguish from a security interest.

127. Professor Ayer described "property" as "the right to enjoy the gains and risk the losses in the value of a particular item." Ayer, *supra* note 34, at 671. In their classic forms, secured transactions and lease transactions can be distinguished on this dimension. The security interest transfers to the debtor both upside opportunity and downside risk. *Id.* at 675. If the collateral is worth more at the end of the deal than the parties anticipated, the debtor captures the benefit of that enhanced value; if, on the other hand, the property is worth less than the parties expected, the debtor is nonetheless obligated to pay the price agreed upon by the parties. In its "pure" form, a lease does not transfer the upside opportunity or the downside risk to the lessee, at least as far as the residual is concerned. (As Ayer pointed out, one must distinguish risk as to the lease term itself from risk regarding the residual.) *Id.* at 680.

The problem is that "the risks and rewards in question can be the subject of an infinite variety of allocations between the parties." *Id.* at 670. Thus, Professor Ayer concluded that "no tenable distinction between lease and security interest" exists, *id.* at 684-85, and that no satisfactory explanation of why bankruptcy treats these two transactions so differently can be found. *Id.* at 685.

Professor Eisenberg raised a similar question regarding secured and unsecured debts. He pointed out that secured and unsecured debts differ more in degree than in kind, which leads to questions whether bankruptcy's favorable treatment of secured credit is justified:

> One might question, therefore, whether secured credit is sufficiently different in kind from other credit to justify sheltering secured credit from bankruptcy's levelling effect. Grants of security are, after all, merely additional terms in a contract. An unsecured lender has inchoate rights in a debtor's nonexempt property. Although these rights usually depend on obtaining and enforcing a judgment, they also include other property-specific attributes, such as the ability to bring fraudulent conveyance and bulk transfer challenges against certain transfers. Through financial covenants and other contractual terms, some unsecured lenders have enhanced inchoate claims to a debtor's property.
>
> Security agreements, though they theoretically confer rights in specific property, are merely another version of enhanced rights. The secured creditor's idealized status often is tarnished by reality. A secured party must observe limitations on breaches of the peace, limitations on the time and place of sale, and limitations on the

Analysis of the economic interests of creditors holding a security interest in equipment and of equipment lessors reveals the difficulty in justifying the line bankruptcy law currently draws. From the point of view of both lessors and secured parties, these transactions serve substantially similar economic functions. Both leases and security agreements divide economic interests in the subject property. Both lessors and secured parties give up use and possession of the equipment that is the subject of their transactions, and both of their respective transferees obtain the enjoyment of those incidents.[128] The transferees obtain possession and use[129] of equipment without an upfront payment of the entire price[130] that cash purchase would require. Casualty risk and the obligation to obtain insurance is typically transferred as well,[131] along with the responsibility for maintenance and repairs, license fees, and even taxes.[132] The transferors obtain the right to receive a stream of payments and, in addition, avoid the risk of being left as unsecured creditors that would be faced if the equipment had been

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> amount of value that may be realized from collateral. State laws imposing significant restrictions on secured creditors' rights to realize upon their collateral highlight the continuity between secured and unsecured forms of debt. Furthermore secured creditors' rights are subordinate to those of a large class of claimants—buyers in the ordinary course of business—and secured creditors have uncertain rights as against some lien creditors.
>
> These factors suggest that the difference between secured and unsecured forms of debt is more one of degree than of kind. If this is true, then the pertinent question is not whether bankruptcy law should depart from state law treatment of security, but whether bankruptcy law should depart from state law treatment of unsecured credit without also doing so for secured credit.

Eisenberg, *supra* note 93, at 961 (footnote omitted).

128. From the debtor's point of view, the incidents of property enjoyed in equipment that is either leased or subject to a security interest are sufficient to bring the equipment into the estate under § 541 and to trigger automatic stay protection under § 362. For the lessor or secured party, the incidents of property are sufficient to trigger constitutional protection.

129. In this respect, the lease is analogous to a more specific type of security interest—the purchase money security interest—since both allow the transferee to obtain rights in property he did not previously have. The purchase money security interest enjoys a favored status under Article 9, see, *e.g.*, U.C.C. §§ 9-302(1)(d), 9-312(3) & 9-312(4), but bankruptcy does not distinguish between purchase money and nonpurchase money security interests in the respects relevant to this Article's discussion. Bankruptcy does draw such distinctions elsewhere. *See, e.g.*, 11 U.S.C. §§ 362(b)(3), 522(f)(2) & 546(b) (1988).

130. Lessors and secured parties are not alone. Other types of voluntary creditors—including employees, suppliers on open account, and utility companies—also fund the debtor in one respect or another.

131. Section 2A-218(1) of the U.C.C. gives the lessee an insurable interest as soon as goods are identified to the lease contract, but subsection (3) provides that the lessor retains an insurable interest until the lessee exercises an option to buy. Subsection (5) provides that the lease contract may allocate the obligation to insure, thus reflecting "the common practice of shifting the responsibility and cost of insuring the goods between the parties to the lease transaction." U.C.C. § 2A-218 official comment.

132. *Hearings*, Part 3, *supra* note 94, at 1866 (statement of the American Association of Equipment Lessors, Inc.). This is true even though liability for taxes may follow ownership and ownership typically stays with lessors but not secured parties (other than creditors under conditional sales agreements).

transferred in exchange for the transferees' bare promise to pay later. An essential function of both security[133] and leasing is allocation of the risk of nonpayment. In fact, it is the essential similarity of the nonbankruptcy[134] risk of default faced by secured parties and lessors that allows approximation of security interests by use of the lease device,[135] even one that passes muster as a true lease. These nonbankruptcy risks are diminished for lessors and secured parties, as compared with unsecured parties, because of the in rem rights and priority rights that are characteristic of both leases and security interests.[136]

Professor Eisenberg has pointed out that security interests carry both in rem and priority rights,[137] but only the latter are enforced in bankruptcy. Possession of a state law security interest acts in bankruptcy "as a ranking mechanism, with secured creditors ranked ahead of unsecured creditors."[138] Secured status translates "into a priority claim equal to the value of the creditor's collateral," and "secured creditors have merely a right to be paid ahead of other creditors to the extent of the value of the secured creditors' collateral."[139] Bankruptcy, in other words, distinguishes between honoring state law rights themselves and honoring the economic value of those rights. State law in rem rights to possession of collateral are not honored in bankruptcy, because to do so would make reorganization impossible. Thus, the secured party's collateral can be retained and used by the estate. The value of the collateral, however, must be adequately protected in the meanwhile and the secured creditor must ultimately be paid at least that much.[140]

Lease transactions carry a similar, but more complex, duality. A lessor has an interest in the term of the lease, which comes down to an interest in receiving the called-for rentals during the lease term.[141] In rem rights

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133. Rogers, *supra* note 93, at 1025.

134. One cannot refer to the risks within bankruptcy, since that is the allocation under scrutiny.

135. White, *supra* note 20, at 504-05.

136. Because both leases and security interests carry rights in designated items of property, they also carry similar economic incentives to monitor. *See* Jackson, *supra* note 32, at 899.

137. Eisenberg, *supra* note 93, at 933-34, 951-55.

138. *Id.* at 933.

139. *Id.* at 952.

140. The Report of the Bankruptcy Commission made clear that the secured creditor should be able to demand no more than the value of the secured claim:

> If a secured creditor is protected to the extent of the value of his collateral, there is no reason why he should be able to prevent the confirmation and consummation of a plan proposed by a debtor for the payment of his debts out of future income. . . . The proposal does not contemplate that the creditor so secured should be entitled to insist that the plan strictly preserve all of the terms of his original contract if the value of his claim against the property of the debtor is preserved.

REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, H.R. DOC. No. 137, Part I, 93rd Cong., 1st Sess. 166 (1973) [hereinafter COMMISSION REPORT].

141. This is the value of the bargain itself. If the lease is not assumed, the amount of any pre-existing default is an unsecured claim. This amount plus "future" damages based

enjoyed by the lessor during the term permit the lessor, like a secured party, to recover the equipment itself in the event of default by the debtor-lessee. The significance of in rem rights upon default, therefore, is remedial for both lessors and secured parties, and their nonbankruptcy rights upon default are very similar.[142] Bankruptcy treats the lessor's interest during the term as an unsecured claim (to the extent of any breach, and if the lease is not assumed). If the lease is assumed, however, bankruptcy honors these in rem rights; previous defaults must be cured, which gives these obligations an in rem-like status, and failure to meet the lease terms in the future triggers the lessor's in rem right to take possession of the leased property.

The lessor's in rem rights also include reversionary rights in the equipment that will be returned at the end of the term.[143] In bankruptcy, the lessor's reversionary interest is treated as an inviolable in rem right whether the lease is assumed or not, since even an assumed lease disappears as property of the estate upon expiration of the term. The lessor's residual, however, bears some functional similarity to the secured party's rights in the collateral.[144] In the context of equipment leasing, the functional value of the residual to the lessor is its utility in putting the lessor ahead of other creditors of their common debtor, *i.e.*, the priority element. Both the remedial and residual elements of the lessor's in rem rights are, in essence, ways of obtaining payment of the obligation owed ahead of other creditors; the functional value of in rem rights to both lessors and secured parties comes down to this. Thus, the significant attribute of the property right for the lessor as well as for the secured party is the priority that comes with it. And the impact on the bankruptcy estate created by honoring the lessor's in rem rights is as great as the potential impact of honoring a secured party's—a potential that has, in the case of secured parties, justified a different rule.

Honoring the in rem rights of lessors in bankruptcy, while disregarding those of secured parties, is not justified on the grounds that the equipment that is the subject of the lease is of greater significance to the lessor than is the equipment that is collateral under a security arrangement. While it may be different for other types of leases,[145] the equipment lessor usually

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upon breach of the lease (subject to the cap, in the case of real estate leases, under § 502(b)(6)) is the lessor's total unsecured claim. Thus, the lessor's claim based on the value of the bargain is analogous to the undersecured creditor's unsecured claim.

142. This is especially true now that Article 2A, with its remedies provisions patterned after those of Articles 2 and 9, has been promulgated. *See supra* notes 37-39.

143. This aspect of the lessor's interest is often subsumed under the concept of title to the leased equipment. *See, e.g.*, Fogel, *supra* note 51, at 374.

144. Kripke, *supra* note 95, at 729. The longer the term of the lease and the lower the value of the reversionary interest, the more the lessor's rights, in an economic sense, resemble those of the secured party. (The greater also is the chance that technical legal rules will deem the transaction a security lease.)

Professor Johnson argued the similar point that the reversionary rights of a lessor of real estate are akin to a mortgagee's right of foreclosure. Johnson, *supra* note 99.

145. *See infra* notes 216-23 and accompanying text.

has no more interest in the equipment itself[146] than does the secured party.[147] The functional significance of the lessor's state law rights lies in the remedial advantages they provide the lessor. In this sense, therefore, the essential attributes of the lessor's property rights are identical to those of the secured party, and bankruptcy should treat them alike.

This conclusion is not altered by pointing to the disruption such an approach would create in the legitimate expectations of the parties. The short answer is that bankruptcy is in the business of disregarding expectations that are rooted in rights and obligations created by state law. The longer answer comes out at the same place. The core expectations of lessors, just as with secured parties, revolves around the allocation of risk. That, in turn, centers upon priority. The argument advanced in this Article maintains priority for lessors by honoring the economic value of that priority. Even if it did not, however, the strength of the argument based upon expectations depends upon the legitimacy of those expectations, and we have a long history of retroactive application of bankruptcy laws that disrupt creditor expectations.[148] The shift in treatment accorded secured parties in the 1978 Code parallels the shift in treatment recommended here for lessors. That shift was permissible for lienors,[149] and it should not be

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146. According to Professor Kripke, "there are few lessors, whether merchants or financial people, who are enamored of the equipment as such or plan to use and keep it and would resist selling it. The residual is just an additional right to provide an additional return of or on the lessor's investment . . . ." Kripke, *supra* note 95, at 729.

Indeed, if the lease is the not uncommon tripartite financing lease, then the lessor is a mere financer who never had possession of the leased goods, is not conducting a business utilizing such goods, and is taking legal title to those particular goods only because the lessee selected them. *See, e.g., In re* Gehrke Enters., Inc., 1 Bankr. 647 (Bankr. W.D. Wis. 1979).

Article 2A defines a finance lease as "a lease in which (i) the lessor does not select, manufacture or supply the goods, (ii) the lessor acquires the goods . . . in connection with the lease, and (iii) either the lessee receives a copy of the contract evidencing the lessor's purchase of the goods on or before signing the lease contract, or the lessee's approval of the contract evidencing the lessor's purchase of the goods is a condition to effectiveness of the lease contract." U.C.C. § 2A-103(1)(g).

147. According to Professor Rogers,

> the identity of the specific property involved is perhaps the matter of least importance to the secured creditor. The secured creditor has no concern about the collateral per se. Rather, the secured creditor's concerns are only that the collateral have and retain sufficient value to satisfy his claim and that it be readily salable . . . .

Rogers, *supra* note 93, at 992.

148. *Id.* at 1026-27.

149. In *In re* Lake's Laundry, Inc., 79 F.2d 326 (2d Cir.), *cert. denied sub nom.* Lake's Laundry, Inc. v. Braun, 296 U.S. 622 (1935), the Second Circuit held that property sold pursuant to a conditional sales agreement was not property of the debtor and, thus, could be reclaimed from the buyer's bankruptcy estate by the nonbankrupt seller. Judge Learned Hand, in dissent, wrote words easily applicable, with but a change or two, to the argument advanced in this Article:

> It seems to me a barren distinction, though indubitably true, that title does not pass upon a conditional sale; "title" is a formal word for a purely conceptual notion; I do not know what it means and I question whether anybody does, except perhaps

made impermissible for lessors on the grounds that it would disrupt their legitimate expectations.

In an important theoretical sense, however, the lessor's residual may represent an interest unlike any enjoyed by the secured party. That difference lies in the probability that the economic value of the residual has not been amortized in the monthly rental payments called for by the lease agreement, and thus, that the full economic value of the property has not been conveyed by the transaction. In the case of a security interest, the total price paid is expected to reflect the cash price of the equipment plus interest sufficient to compensate for risk and the time value of money. In the case of a lease, on the other hand, the monthly rental over the term of the lease may not pay the full cash price plus interest.[150] Indeed, one of the reasons for leasing equipment in the first place, rather than buying on credit, is that the

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> legal historians. The relations resulting from conditional sales are practically the same as those resulting from mortgages; I would treat them as the same when we are dealing with the reorganization of the debtor's property.

79 F.2d at 328-29 (Hand, J., dissenting).

Lake's Laundry was relied upon 30 years later by the Fruehauf Corporation, which had sold truck bodies and trailers to Yale Express System, Inc. under a contract requiring payment a specified number of days after delivery. When Fruehauf later learned that Yale Express' financial statements, on which it had relied, were incorrect, it negotiated an installment purchase agreement with Yale Express, taking and perfecting a chattel mortgage in the equipment. Yale Express later filed bankruptcy and Fruehauf sought to reclaim the equipment, relying on *Lake's Laundry*. The Second Circuit held, however, in *In re* Yale Express Sys., Inc., 370 F.2d 433 (2d Cir. 1966), that the distinction between conditional sales agreements and chattel mortgage agreements had become anachronistic, given the wide adoption of the U.C.C.:

> We, therefore, in keeping with the developments in the body of recent commercial law, conclude that Fruehauf's right to reclaim the trailers and truck bodies cannot hang on whether its security agreement is labeled a "conditional sales contract" or a "chattel mortgage." Since the Uniform Commercial Code has abolished the technical distinctions between the various security devices, the federal bankruptcy courts should no longer feel compelled to engage in the purely theoretical exercise of locating "title;" nor should considerations of where "title lies" influence courts in the exercise of their equitable discretion. . . . Equitable considerations and the *substance* of the transaction should govern, regardless of the *form* of the security agreement.

Id. at 437-38 (footnote omitted).

150. This point is complicated by the fact that whether the residual has been amortized is not a factor in distinguishing a sale from a lease under the U.C.C.:

> A transaction does not create a security interest merely because it provides that
> (a) the present value of the consideration the lessee is obligated to pay the lessor for the right to possession and use of the goods is substantially equal to or is greater than the fair market value of the goods at the time the lease is entered into.

U.C.C. § 1-201(37), para. 3. Thus, Professor Ayer's conclusion that "[i]f the lessee is paying the entire purchase 'price' and has power to 'buy' the asset, he has acquired . . . the property, and the transaction is no longer a lease but is a sale with retention of security only" is not correct under the revised version of UCC § 1-201(37). Ayer, *supra* note 34, at 673 (footnote omitted).

monthly cost may be lower. If it is lower, that is theoretically because the economic value of the residual has not been amortized.

The lessor is not undercompensated in such a situation by receiving the value of the collateral (plus an unsecured claim for the balance owed under the lease) if the standard for full compensation in bankruptcy is determined by what the nonbankrupt party would receive under state law if the debtor simply disappeared, either literally or financially. State law gives the secured party the collateral, which can be sold for its value, and a claim against the debtor for the deficiency. A lessor's entitlement is similar: he gets the property back, and a contract claim against the debtor for the balance owed. The debtor fully compensates the lessor for the value of the residual in the same way that a secured party is compensated for the value of its secured claim—by payment of that amount in a lump sum or through a plan providing a stream of payments having a value, as of the date of the plan, of the amount of the residual.[151] The deficiency of the secured party and the contract claim of the lessor are unsecured claims, paid pro rata with all of the debtor's other unsecured claims.[152] Honoring the lessor's in rem rights, rather than just their value, should not be required.

C. *Constitutional Origins*

Lessors and secured parties cannot be treated alike in bankruptcy, despite the commercial irrelevance of the location of title and the functional similarity of their interests, if the different treatment currently accorded them has constitutional significance. The contractual rights of secured parties are a species of property entitled to constitutional protection,[153] yet bankruptcy does not honor their in rem rights. Thus, the matter must turn on whether attributes of the lessor's property rights are different in constitutionally significant ways from attributes of the secured creditor's property rights.

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151. This also leads to the conclusion that the trustee should be able to disregard postbankruptcy termination clauses and to continue using leased property. The Code, in fact, currently so provides. 11 U.S.C. § 363(l) (1988). Given that such use consumes the residual, the lessor is entitled to adequate protection to the extent of the collateral's diminished value. 11 U.S.C. § 363(e) (1988).

It is not necessarily true in every case that the value of the residual has not been amortized, however. A transaction may be a true lease under the U.C.C. even though the lease payments total more than the cash price of the leased goods. U.C.C. § 1-201(37), para. 3(a). Requiring payment of the value of the residual in bankruptcy would overcompensate the lessor in such cases. Entitlement to such compensation, therefore, should depend upon a showing that the monthly payments did not amortize the value of the residual.

152. Lessors believing that such treatment is not compensatory can protect themselves by adjusting the lease price to take this result into account. The only difficult cases would be those leases already in existence, with price terms determined in light of § 365's existing rules. *See generally* Kaplow, *An Economic Analysis of Legal Transitions*, 99 HARV. L. REV. 511 (1986).

153. The Supreme Court has long recognized that contract rights are a form of property. United States v. Security Indus. Bank, 459 U.S. 70, 76 n.6 (1982); United States Trust Co. v. New Jersey, 431 U.S. 1, 19 n.16 (1977); Lynch v. United States, 292 U.S. 571, 579 (1934).

Clearly, the lessor's title cannot itself be an attribute bearing constitutional significance. If it were, a substantial number of nonbankruptcy and bankruptcy provisions would be unconstitutional. Begin with section 1-201(37) of the U.C.C. It determines what transactions, although denominated leases, are in fact intended for security and, therefore, are to be governed by Article 9. Article 9 requires, generally, some sort of public filing in order to defeat the claims of competitors, including holders of judicial liens. Section 544(a) allows the trustee to avoid interests, including unfiled security interests, that are vulnerable to judicial lien creditors. Thus, if a transaction denominated a lease is found to be a disguised security interest under section 1-201(37) and no financing statement was filed, the lease is treated as an unperfected security interest in bankruptcy, and the trustee will be able to avoid it under section 544(a).[154] Retention of title by the nominal lessor does not prevent the result, and no constitutional rights of the titleholder are infringed thereby.[155] Similarly, a fraudulent conveyance is avoidable under section 548,[156] and a transfer to pay an antecedent debt can be avoided under section 547 if the additional requirements for avoiding preferences are satisfied.[157] Transfers avoided as fraudulent or preferential may have passed formal title, yet the avoiding powers stand. If title alone carried constitutional significance, these bankruptcy avoiding powers would also be unconstitutional.

Inquiry into whether lessors' and secured parties' property rights are different in constitutionally significant ways is complicated by the fact that

154. Section 544(a)(1) of the Bankruptcy Code gives the trustee the avoiding power a judicial lien creditor would have under state law if such a creditor were in existence at the time bankruptcy was filed. Section 9-301(1)(b) of the U.C.C., which provides that "an unperfected security interest is subordinate to the rights of . . . a lien creditor," is a state law grant of an avoiding power. Because leases that are found to be disguised security interests are unlikely to be perfected, *but see* U.C.C. § 9-408, they are thus vulnerable to avoidance by the trustee as a hypothetical lien creditor. *See, e.g.*, *In re* Marhoefer Packing Co., 674 F.2d 1139 (7th Cir. 1982); *In re* Beker Indus. Corp., 69 Bankr. 937 (Bankr. S.D.N.Y. 1987), *rev'd on other grounds*, 89 Bankr. 336 (S.D.N.Y. 1988).

155. The court in *In re* Peaches Records & Tapes, 51 Bankr. 583 (Bankr. 9th Cir. 1985), held that retrospective application of § 365 does not take property in violation of the Fifth Amendment; rather, it merely readjusts the lessor's bundle of rights. *Cf.* Holt v. Henley, 232 U.S. 637 (1914), giving prospective application to an early version of 11 U.S.C. § 544(a), and commenting that "[w]e do not need to consider whether or how far in any event the constitutional power of Congress would have been limited." *Id.* at 639.

156. 11 U.S.C. § 548 (1988). The trustee may also avoid fraudulent transfers under § 544(b), which gives the trustee avoiding powers an actual unsecured creditor enjoys under state law. Typical state law provisions giving unsecured creditors power to avoid fraudulent transfers are the Uniform Fraudulent Conveyance Act (1918) and the more recent Uniform Fraudulent Transfer Act (1984).

157. Additionally, the transfer must have been made to a creditor during the 90 days preceding the filing of bankruptcy (or within the preceding year if the transferee was an insider), it must have been made while the debtor was insolvent, and it must enable the creditor to receive more than he would if the transfer had not been made and he simply took the share to which he would be entitled in a liquidation under Chapter 7. 11 U.S.C. § 547(b) (1988).

the Supreme Court has not developed a refined analysis of the relationship between contract and property rights in the bankruptcy context generally, much less in the context of the lease-security interest relationship. Review of the relevant cases, however, reveals no significant difference in the Court's analysis when property rights, rather than contract rights, are at stake or when lessors' rights, rather than secured creditors' rights, are involved.

The starting point is the early 1930s, when statutory provisions were enacted in reaction to the economic distress of the Great Depression. These provisions were the first to interfere with the substantive rights of creditors claiming interests in specific items of the debtor's property.[158] Early cases dealing with these provisions all involved the rights of lienors, rather than lessors, and spoke primarily in contract terms. Taken as a whole, they developed at least two propositions that we now find unremarkable: first, that constitutional analysis does not differ depending upon whether the rights involved are described as property rights or contract rights; and second, that the constitutional rights of secured parties are not violated in bankruptcy by honoring the economic value of those rights, rather than the rights themselves.[159]

The first case, *Home Building & Loan Association v. Blaisdell*,[160] involved a state mortgage moratorium statute under which foreclosure sales could be postponed and redemption periods extended. Because the mortgagee's primary attack was based on the contracts clause and the Court's discussion focused on it, at first blush the case may appear not particularly relevant to a discussion of Congress' bankruptcy power in relation to lessors and secured parties. The *Blaisdell* mortgagee, however, also raised a due process attack and the Court stated, somewhat cryptically, that what was said on the contracts clause issue was equally applicable to the due process argument.[161] *Blaisdell*, therefore, is pertinent to an inquiry into the nature of property and contract rights of, especially, secured parties.

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158. The first enactment to do so was the Frazier-Lemke Act, which was held unconstitutional in Louisville Joint Stock Land Bank v. Radford, 295 U.S. 555 (1935). See *infra* notes 172-78 and accompanying text.

159. One of the reorganization chapters under the Bankruptcy Act, Chapter XI, did not permit the plan to affect secured claims, COMMISSION REPORT, *supra* note 140, at 24, and the view was expressed during hearings on new bankruptcy provisions proposed in the 1970s that interference with a secured party's rights would be unconstitutional. *Hearings*, Part 3, *supra* note 94, at 1363 (statement of Alvin O. Wiese, Jr.).

160. 290 U.S. 398 (1934). *Blaisdell* "is regarded as the leading case in the modern era of Contract Clause interpretation." United States Trust Co. v. New Jersey, 431 U.S. 1, 15 (1977).

161. Home Bldg. & Loan Assoc. v. Blaisdell, 290 U.S. 398, 448 (1934). Because the Fifth Amendment constrains Congress' power, Louisville Joint Stock Land Bank v. Radford, 295 U.S. 555, 589 (1935); L. TRIBE, AMERICAN CONSTITUTIONAL LAW § 9-5, at 465 n.1 (1978), rather than the contracts clause, any discussion of permissible bankruptcy provisions must take due process into account. (*But see* Rogers, *supra* note 93, at 997-1012, arguing that Congress' bankruptcy power is limited only by the bankruptcy clause and not by the Fifth Amendment.) The analysis is substantially identical, however, *see* G. STONE, L. SEIDMAN, C. SUNSTEIN &

The *Blaisdell* majority acknowledged that the statute interfered with the mortgagee's otherwise-applicable state law rights.[162] Nevertheless, the majority held that the statute's interference did not rise to the level of unconstitutionality:

> Aside from the extension of time, the other conditions of redemption are unaltered. While the mortgagor remains in possession he must pay the rental value as that value has been determined, upon notice and hearing, by the court. The rental value so paid is devoted to the carrying of the property by the application of the required payments to taxes, insurance, and interest on the mortgage indebtedness, [sic] While the mortgagee-purchaser is debarred from actual possession, he has, so far as rental value is concerned, the equivalent of possession during the extended period.[163]

Although the majority and the dissent differed on the degree of interference attributable to the statute,[164] both approached the case as presenting a

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M. TUSHNET, CONSTITUTIONAL LAW 1444 (1986), so one can safely assume that enactments passing muster under the contracts clause, if passed by state legislatures, would pass muster under due process if passed by Congress.

162. The Court assumed:

> that the mortgage contained a valid power of sale to be exercised in case of default; that this power was validly exercised; that under the law then applicable the period of redemption from the sale was one year and that it has been extended by the judgment of the court over the opposition of the mortgagee-purchaser; and that during the period thus extended, and unless the order for extension is modified, the mortgagee-purchaser will be unable to obtain possession, or to obtain or convey title in fee, as he would have been able to do had the statute not been enacted.

290 U.S. at 424-25.

163. *Id.* at 425.

164. The majority presented the interference as a fairly minor matter of remedy:

> The conditions upon which the period of redemption is extended do not appear to be unreasonable. The initial extension of the time of redemption for thirty days from the approval of the Act was obviously to give a reasonable opportunity for the authorized application to the court. As already noted, the integrity of the mortgage indebtedness is not impaired; interest continues to run; the validity of the sale and the right of a mortgagee-purchaser to title or to obtain a deficiency judgment, if the mortgagor fails to redeem within the extended period, are maintained; and the conditions of redemption, if redemption there be, stand as they were under the prior law. The mortgagor during the extended period is not ousted from possession but he must pay the rental value of the premises as ascertained in judicial proceedings and this amount is applied to the carrying of the property and to interest upon the indebtedness. The mortgagee-purchaser during the time that he cannot obtain possession thus is not left without compensation for the withholding of possession.

290 U.S. at 445. The dissent, on the other hand, viewed the statute as much more intrusive:

> It will be observed that whether the statute operated directly upon the contract or indirectly by modifying the remedy, its effect was to extend the period of redemption absolutely for a period of sixteen days, and conditionally for a period of two years. That this brought about a substantial change in the terms of the contract reasonably cannot be denied. If the statute was meant to operate only upon the remedy, it, nevertheless, as applied, had the effect of destroying for two years the right of the

question of lienors' contract rights.[165]

Continental Illinois National Bank & Trust Co. v. Chicago, Rock Island & Pacific Railway[166] dealt with efforts to enjoin creditor actions in state court. The Court clearly saw the case as presenting questions of contract rights. The Court's analysis of the issue—whether the bankruptcy court had power to enjoin pledgees from selling securities held as collateral—was couched squarely in contract terms.[167] Treasury securities of the debtor were pledged to secure loans. If the bonds had been "owned outright by a

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> creditor to enjoy the ownership of the property, and consequently the correlative power, for that period, to occupy, sell or otherwise dispose of it as might seem fit. This postponement, if it had been unconditional, undoubtedly would have constituted an unconstitutional impairment of the obligation.

Id. at 480-81 (Sutherland, J., dissenting).

165. Recent discussion of *Blaisdell* has stressed that the statute in question was an emergency measure, passed by Minnesota "during the depth of the Depression and when that State was under severe economic stress, and appeared to have no effective alternative." United States Trust Co. v. New Jersey, 431 U.S. 1, 15 (1977). In Allied Structural Steel Co. v. Spannaus, 438 U.S. 234, 242 (1978), the Court listed five factors that *Blaisdell* had found significant in upholding the state legislation challenged there. At least three of the five involved the emergency nature of the circumstances leading to enactment of the legislation. The *Spannaus* Court also referred to "the broad and desperate emergency economic conditions of the early 1930's—conditions of which the Court in *Blaisdell* took judicial notice." *Id.* at 249. In a footnote to that statement, however, the *Spannaus* Court hastened to add that "[t]his is not to suggest that only an emergency of great magnitude can constitutionally justify a state law impairing the obligations of contracts." *Id.* at 249 n.24.

166. 294 U.S. 648 (1935).

167. An earlier case, Straton v. New, 283 U.S. 318 (1931), also involved a trustee's efforts to enjoin a state court action. *Straton*, however, failed to frame the issue in either contract or property terms. In *Straton*, bankruptcy was filed five and a half months after a judgment lien creditor began a creditor's suit in state court. The bankruptcy trustee and two senior mortgagees who had been joined in the state suit sought to enjoin it. The Supreme Court framed the question as whether "the bankruptcy of defendant occurring more than four months after the institution of the creditors' suit oust[s] the state court of jurisdiction, or vest[s] in the court of bankruptcy power to enjoin further proceedings in the state court?" *Id.* at 320. The Court, however, then discussed the issue in terms that seem, at best, a digression. It discussed cases holding that a creditor may not bring foreclosure in state court after a bankruptcy has been filed—an issue that today would be presented as relating to the automatic stay—and cases holding that action may not be brought on a lien obtained within four months of bankruptcy—an issue we would recognize as a preference. The preference period before 1978 was four months, rather than 90 days as under the current statute. The holding was presented in jurisdictional terms: "[W]here a judgment which constitutes a lien on the debtor's real estate is recovered more than four months prior to the filing of the petition, the bankruptcy court is without jurisdiction to enjoin the prosecution of the creditor's action, instituted prior to the filing of a petition in bankruptcy, to bring about a judicial sale of the real estate." *Id.* at 326. Thus, the case has elements of several questions—the validity of liens under preference law, jurisdiction, the pass-through of valid liens, and turnover of property to the trustee. (To the extent that *Straton* is relevant to the question of turnover, it seems contrary to the much more recent *Whiting Pools* case, discussed at note 28 *supra*.) Although the Court characterized the judgment creditor's interest as a lien and remarked that the lienor was merely vindicating his prebankruptcy rights, 283 U.S. at 329, little was offered to clarify the contract or property nature of the lienor's interest.

creditor,"[168] they would have constituted obligations of the debtor to pay the amount specified in the bond. Until sold, however, they did not carry this attribute. Thus, sale by the pledgee-banks to the public would have increased the debtor's obligations and led to default. Debtor sought to enjoin such a sale.

The pledgees' principal argument fudged any distinction between contract and property. They argued that section 77 of the Bankruptcy Act,[169] as applied to permit an injunction, violated the Fifth Amendment: "The basis of the contention is that since, by the terms of the pledge, the pledgors are empowered on default to sell the collateral at such times as they may select, § 77, as thus applied, *deprives them of their property—that is to say, impairs or destroys their contractual rights*—without due process of law."[170] The Court, however, held that an injunction was proper because the threatened sale would prevent formulation and consummation of a reorganization plan. The Court responded in purely contract terms:

> Speaking generally, it may be said that Congress, while without power to impair the obligation of contracts by laws acting directly and independently to that end, undeniably, has authority to pass legislation pertinent to any of the powers conferred by the Constitution, however it may operate collaterally or incidentally to impair or destroy the obligation of private contracts. . . . And under the express power to pass uniform laws on the subject of bankruptcies, the legislation is valid though drawn with the direct aim and effect of relieving insolvent persons in whole or in part from the payment of their debts. . . .
>
> The injunction here goes no further than to delay the enforcement of the contract. It affects only the remedy. As already appears, this court has upheld the power of a court of bankruptcy to stay the enforcement of the remedy under a real-estate mortgage; and the remedy under a pledge, so far as constitutional power is here concerned, presents a situation strictly analogous in character.[171]

Use of contract language to analyze a secured creditor's interests seemed firmly planted by *Continental Illinois*. The next two important cases, however, departed from the contracts approach and spoke of property rights. Both involved the Frazier-Lemke Act, which was passed during the Depression in an effort to provide relief to distressed farmers.

168. Brief of Respondent, Protective Comm. for the Chicago, Rock Island & Pac. Ry. Co. Gen. Mortgage Bonds, at 8 (Microcard Editions, Inc. Card 15), Continental Ill. Nat'l Bank v. Chicago, Rock Island & Pac. Ry. Co., 294 U.S. 648 (Nos. 34-479 & 480) (1935).

169. Section 77 of the Bankruptcy Act provided for reorganization by railroads. It is what we would know today as a "chapter" rather than a "section.

170. Continental Ill. Nat'l Bank v. Chicago, Rock Island & Pac. Ry. Co., 294 U.S. 648, 680 (1935) (emphasis added).

171. *Id.* at 680-81 (citations omitted).

Louisville Joint Stock Land Bank v. Radford[172] dealt with the first version of the Frazier-Lemke Act, which applied only to debts existing at the time it became effective. Under paragraph 3 of the Act, the debtor could purchase mortgaged property with the mortgagee's consent, receiving title and immediate possession, and pay its then appraised value on a deferred basis: two and a half percent within two years; two and a half percent within three years; five percent within four years; five percent within five years; and the balance within six years; all deferred payments bearing interest at one percent per annum. If the mortgagee did not agree to this debtor-favorable deal, the debtor could, under paragraph 7 of the Act, stay all proceedings for five years and retain possession of the property, meanwhile paying its reasonable rental value. At any time during the five years, the debtor could pay the appraised price—either the original appraisal or a reappraised price, if the lienor requested a reappraisal—and obtain title and possession. Thus, the debtor controlled the time of sale and could choose to purchase when prices were depressed.

The Court asserted that the Frazier-Lemke Act was the first statute requiring a mortgagee to relinquish mortgaged property to the debtor free of the lien without first requiring the debtor to pay the debt in full.[173] The Act took "substantive rights in specific property" away from the mortgagee and thereby ran afoul of the Fifth Amendment.[174] Paragraphs 3 and 7 of the Act were both constitutionally infirm because each allowed the debtor to pay less than the debt.[175]

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172. 295 U.S. 555 (1935).

173. Louisville Joint Stock Land Bank v. Radford, 295 U.S. 555, 579, 581, 588-89 (1935). Other cases—including *Continental Illinois*, discussed *supra* notes 166-71 and accompanying text, and *Straton*, discussed *supra* in note 167—were distinguished as affecting only the remedy. *Id.* at 583.

Despite the apparent suggestion that only payment of the debt in full will do, current law certainly permits payment, in the event of undersecurity, of the lesser amount of collateral value rather than the greater amount of debt.

174. *Id.* at 589-90.

175. Under the transaction envisioned by paragraph 3:

> [t]he mortgagee would not get the ordinary fruits of an immediate sale on deferred payments; for the bankrupt would make no down payment at the time of taking possession and would give no other assurance that the payments promised would in fact be made. And, if all such payments were duly made, the sale would not be at the appraised value; for the value of money (even if there were no risk) is obviously more than one per cent. By restricting, throughout the period of six years, the annual interest on the deferred payments to one per cent., a sale at much less than the appraised value is prescribed.

Id. at 591 (footnote omitted). The Court found the nonconsensual sale envisioned by paragraph 7 similarly infirm:

> If the mortgagee refuses to consent to the agreement to sell under Paragraph 3, he is compelled, by Paragraph 7, to surrender to the bankrupt possession of the property for the period of five years; and during those years, the bankrupt's only monetary obligation is to pay a reasonable rental fixed by the court. . . . During that period the bankrupt has an option to purchase the farm at any time at its appraised, or reappraised, value. The mortgagee is not only compelled to submit to

In declaring the Frazier-Lemke Act unconstitutional on due process grounds, the Court abandoned the contract language of prior cases involving the rights of lienors and spoke in terms of property rights. The Act's impermissible aspect was "the taking of substantive rights in specific property acquired by the [mortgagee] prior to the Act."[176] The Court listed five elements comprising the substantive property rights given to the mortgagee by state law[177] beyond the mere right to have the value of the collateral applied in satisfaction of the obligation.[178] It was the Act's interference with these state law property rights that compelled its invalidation.

Congress responded to the *Radford* decision by amending the Frazier-Lemke Act. As amended, the Act applied to both existing and future liens. It allowed a debtor to maintain possession of the property for three years before paying its appraised value, unless the supervising court ordered sale to occur earlier. The fact that delay was not absolute, but rather was subject to court supervision and discretion, was the primary factor leading the Supreme Court to reject the constitutional challenge to the amended version of the Act in *Wright v. Vinton Branch of the Mountain Trust Bank*.[179]

The mortgagee's chief argument in *Vinton Branch* was that the three year stay was absolute in essence, and thus denied the mortgagee its "right to determine when such sale shall be held, subject only to the discretion of the court,"[180] which was one of the five elements of a mortgagee's rights that the prior version of the Act was found in *Radford* to have impaired.[181] The Court disagreed as to the Act's effect, however, finding that the moratorium could be lifted if, for example, the debtor failed to pay the

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> the sale to the bankrupt, but to a sale made at such time as the latter may choose. . . . The mortgagee cannot require a reappraisal when, in its judgment, the time comes to sell; it may ask for a reappraisal only if and when the bankrupt requests a sale. Thus the mortgagee is afforded no protection if the request is made when values are depressed to a point lower than the original appraisal.

Id. at 592-93 (footnote omitted).

176. *Id.* at 590.

177. Those elements were:

> 1. The right to retain the lien until the indebtedness thereby secured is paid.
>
> 2. The right to realize upon the security by a judicial public sale.
>
> 3. The right to determine when such sale shall be held, subject only to the discretion of the court.
>
> 4. The right to protect its interest in the property by bidding at such sale whenever held, and thus to assure having the mortgaged property devoted primarily to the satisfaction of the debt, either through receipt of the proceeds of a fair competitive sale or by taking the property itself.
>
> 5. The right to control meanwhile the property during the period of default, subject only to the discretion of the court, and to have the rents and profits collected by a receiver for the satisfaction of the debt.

Id. at 594-95.

178. *Id.* at 596.

179. 300 U.S. 440 (1937).

180. Wright v. Vinton Branch of the Mountain Bank, 300 U.S. 440, 460 (1937).

181. *Radford*, 295 U.S. at 594-95. The elements are quoted *supra* note 177.

reasonable semi-annual rental required by the revised Act.[182] The Court stated that the question raised by the mortgagee's objections "is not whether the Act does more than modify remedial rights. It is whether the legislation modifies the secured creditor's rights, remedial or substantive, to such an extent as to deny the due process of law guaranteed by the Fifth Amendment."[183] The Court listed the ways in which a bankruptcy court may affect the interests of lienors[184] and concluded that the revised version of the Frazier-Lemke Act made "no unreasonable modification of the mortgagee's rights."[185]

The last of the major cases of this period dealing with the rights of lienors was *Wright v. Union Central Life Insurance Co.*[186] In *Wright* the

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182. *Wright*, 300 U.S. at 461.

183. *Id.* at 470.

184. In order to achieve the purposes of the bankruptcy statute, a bankruptcy court may direct that all liens upon property forming part of a bankrupt's estate be marshalled; or that the property be sold free of encumbrances and the rights of all lien holders be transferred to the proceeds of the sale. . . . Despite the peremptory terms of a pledge, it may enjoin sale of the collateral, if it finds that the sale would hinder or delay preparation or consummation of a plan of reorganization. Continental Illinois Nat'l Bank & T. Co. v. Chicago. R.I. & P. R. Co., 294 U.S. 648, 680, 681. It may enjoin like action by a mortgagee which would defeat the purpose of subsection (s) to effect rehabilitation of the former mortgagor.

Id. at 470 (citations omitted).

185. *Id.*

186. 304 U.S. 502 (1938). A second case, involving the same debtor and same tract of land, reached the Supreme Court two years later. Wright v. Union Cent. Life Ins. Co., 311 U.S. 273 (1940). In that case the mortgagee argued that debtor had no hope of rehabilitation and sought dismissal of the proceedings or, in the alternative, immediate sale of the land. Debtor, on the other hand, sought to have the land appraised and to redeem at the newly appraised value, without liability for any deficiency, under § 75(s)(3) of the Bankruptcy Act. The statute, which provided for payment of the appraised value at the end of three years, had two provisos, each couched in mandatory terms, that seemed to conflict with one another: first, that upon request of debtor or a creditor, an appraisal shall be done and, upon paying that amount into court, debtor shall obtain possession free of liens; and second, that upon creditor's written request the court shall order sale of the property at public auction.

The Court noted that the statute provided safeguards "to protect the rights of secured creditors, throughout the proceedings, to the extent of the value of the property. There is no constitutional claim of the creditor to more than that." *Id.* at 278 (citations omitted). Thus, the issue presented by the case was one of statutory interpretation—reconciliation of the two provisos. The Court held that debtor's request for redemption under the first proviso could not be defeated by creditor's request for public sale under the second proviso, *id.* at 279, and again stressed, in property rights terminology, the lack of constitutional problems in the statutory scheme:

> Under our construction, . . . the creditor will not be deprived of the assurance that the value of the property will be devoted to the payment of its claim. For, as indicated in *Wright v. Vinton Branch*, 300 U.S. 440, 468, if the debtor did redeem pursuant to that procedure, he would not get the property at less than its actual value. In that case this Court, in sustaining the constitutionality of § 75(s), emphasized that the Act preserved the right of the mortgagee to realize upon the security by a judicial sale. By our construction the exercise of this right is merely deferred or postponed until the other conditions and requirements of the Act, prescribed for the

debtor sought to enjoy the benefit of a newly enacted bankruptcy provision[187] that extended unexpired rights of redemption in real property. The mortgagee had purchased the property at a judicial sale and expected to receive a sheriff's deed upon expiration of the one year state law redemption period.[188] The Court rejected the mortgagee-purchaser's due process challenge and continued the property approach begun in *Radford* and *Vinton Branch*:

> The rights of the purchaser are preserved, the possibility of enjoyment is merely delayed. The rights of a purchaser, who under the state law is entitled to the redemption money or possession within a year, are not substantially different from those of a mortgagee entitled, on the maturity of the obligation, to payment or sale of the property.
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> . . .
>
> Property rights do not gain any absolute inviolability in the bankruptcy court because created and protected by state law. Most property rights are so created and protected. But if Congress is acting within its bankruptcy power, it may authorize the bankruptcy court to affect these property rights, provided the limitations of the due process clause are observed.[189]

None of these cases gave any attention to the contracts approach of previous cases. This inattention cannot be attributed to the nature of the interferences with the rights of lienors that had been previously presented, except to the extent that the Court's distinction between interference with remedy and interference with substance holds up. The Court offered no

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> protection of the debtor, have been met. It is eventually denied the creditor only in case he is paid the full amount of what he can constitutionally claim.

Id.

187. The provision was § 75(n). Subsection 75(s) was upheld against constitutional challenge in Wright v. Vinton Branch of the Mountain Bank, 300 U.S. 440 (1935), discussed *supra* text accompanying notes 179-85.

188. *Wright* is somewhat similar to United States v. Whiting Pools, Inc., 462 U.S. 198 (1983), discussed *supra* note 28, although the Court's analytical approach was quite different in the two cases. In *Wright*, the Court's approach was in terms of property rights under due process. *Whiting Pools* concerned the trustee's power to compel turnover—an issue of when a debtor in bankruptcy ceases to have rights in property sufficient to make the asset in question property of the estate under § 541. The Court noted that ownership of the property, which had been seized by the IRS to satisfy a tax lien, would not pass from the debtor until the property was sold to a bona fide purchaser at a tax sale. *Id.* at 212. Apparently, under the facts presented in *Wright*, ownership of the property did not pass out of the debtor's hands until expiration of the redemption period. In neither *Wright* nor *Whiting Pools* did the Court address whether a secured party who had obtained possession of collateral subject to a security interest by exercising its right to repossess under Article 9 of the U.C.C. was subject to a turnover order. In fact, the *Whiting Pools* Court clearly stated it was not deciding that question, 462 U.S. at 207 n.14, although the reasoning of the case seems applicable to holders of Article 9 security interests.

189. 304 U.S. at 516-18.

explanation for the contracts analysis of *Blaisdell* and *Continental Illinois* versus the property analysis of *Radford, Vinton Branch* and *Wright.*

The Court's only major lease case during this period, *Kuehner v. Irving Trust Co.*,[190] concerned the amount of a landlord's claim in bankruptcy for damages arising from breach of a long-term lease of commercial real property. In *Kuehner*, six years of a twenty year lease term had expired at the time the lessee filed bankruptcy. The trustee rejected the lease and abandoned the premises, and the lessors reentered and terminated the lease. They asserted that their claim[191] should share pro rata with other claims to the extent of three years' rent,[192] and that the balance should be subordinated to other debts, but have priority over stockholders' claims. The lessors argued that if their claim were limited as the statute appeared to do,[193] their allowed claim would in some instances be less than their actual loss. Such a result, they argued, would violate due process.[194] The Court presented the issue in contract terms[195] (which is not surprising, given that the lessors had

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190. 299 U.S. 445 (1937). Another lease case, City Bank Farmers Trust Co. v. Irving Trust Co., 299 U.S. 433 (1937), was decided on the same day. In *City Bank*, the trustee rejected a lease of business premises and abandoned the property. The lessor reentered and relet the premises—a technical surrender that, under state law, had the effect of drowning the estate in the reversion. Relying on this state law consequence, the trustee argued that the landlord could assert no provable claim in bankruptcy because all of the debtor's obligations to the landlord had been extinguished. The Court rejected the trustee's argument:

> The amount of the landlord's claim for the loss of his lease necessarily is the difference between the rental value of the remainder of the term and the rent reserved, both discounted to present worth. . . . If the landlord must give credit for the present rental value of the premises he is entitled to avail himself of them for realization of that value, and this he cannot do without reentry and reletting. If he must give such credit he surely has the option to attempt recoupment of his loss by occupying the premises for the remainder of the term. But such occupation, under the law of most of the states, amounts to a complete termination of the leasehold and deprives the landlord of any further rights as lessor. It is evident that if a lease be rejected the subsequent repossession of the demised premises, and acts of control and dominion do not destroy the provability of a claim under § 77B.

299 U.S. at 443-44.

191. The claim was measured by the difference between the fair rental value of the premises ($111,545) and the rent reserved by the lease for the remainder of the term ($199,237). Note that mitigation is assumed here, as it was in *City Bank*, *supra* note 190.

192. $44,377.

193. The statute, as then written, limited their claim to the difference between the present rental value and the present value of the rent reserved by the lease, with a three-year maximum. That provision is substantially similar to the current statutory cap found in § 502(b)(6).

194. Kuehner v. Irving Trust Co., 299 U.S. 445, 450 (1937).

195. The Court stated:

> Does the Act offend the due process guaranty by destruction of rights conferred by the petitioners' contract? They affirm that it does, not merely by impairing those rights but by a direct taking *pro tanto* of all remedies for their enforcement and, to that extent, of the contract itself. Conceding they have no lien upon, or property right in, the debtor's assets, such as was the subject of decision in *Louisville Joint Stock Land Bank v. Radford*, *supra*, they maintain that the Fifth Amendment assures them some effective procedure for the enforcement of the obligation of their contract;

taken possession of their property) and held that the limitations imposed by Congress on a landlord's claim were not arbitrary and unreasonable, given the uncertainties involved in determining losses caused by breach of long-term leases.[196]

The Court noted that the statutory provision in question had been enacted to give the landlord a claim in the bankruptcy of its tenant in order to avoid the consequence under prior law of leaving a landlord with a claim against a corporate shell, emptied of assets by bankruptcy, or against an assetless individual. Given this statutory purpose, it was

> incorrect to say that Congress took away all remedy under the lease. On the contrary, it gave a new and more certain remedy for a limited amount, in lieu of an old remedy inefficient and uncertain in its result. This is certainly not the taking of the landlord's property without due process.[197]

Thus, *Kuehner* recognized that the contract rights of a landlord under a lease may be altered by Congress in the exercise of its bankruptcy powers without offending other portions of the Constitution.

In summary, this line of cases analyzes the rights of secured parties in both contract and property terms, and analyzes a lessor's rights, in the only lease case of the period, using contract terms. The different analytical approaches of these cases is not explained on the grounds that different constitutional provisions were involved. Each of them was, at least ultimately, a matter of due process,[198] and the cases have gone off on both

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> that the debtor's assets are a trust fund for creditors which cannot be invaded for the benefit of stockholders. As pointed out in the case last cited there is, as respects the exertion of the bankruptcy power, a significant difference between a property interest and a contract, since the Constitution does not forbid impairment of the obligation of the latter. The equitable distribution of the bankrupt's assets, or the equitable adjustment of creditors' claims in respect of those assets, by way of reorganization, may therefore be regulated by a bankruptcy law which impairs the obligation of the debtor's contracts. Indeed every bankruptcy act avowedly works such impairment. While, therefore, the Fifth Amendment forbids the destruction of a contract it does not prohibit bankruptcy legislation affecting the creditor's remedy for its enforcement against the debtor's assets, or the measure of the creditor's participation therein, if the statutory provisions are consonant with a fair, reasonable, and equitable distribution of those assets. The law under consideration recognizes the petitioners' claim and permits it to share in the consideration to be distributed in reorganization. The question is whether the remedy is circumscribed in so unreasonable and arbitrary a way as to deny due process.

299 U.S. at 451-52.

196. *Id.* at 454. For criticism of this view, see T. JACKSON, *supra* note 14, at 56-57.

197. 299 U.S. at 453.

198. Even cases that began with questions concerning the scope of the bankruptcy power, such as *Continental Illinois*, *supra* notes 166-71 and accompanying text, devolved into questions of due process because the bankruptcy power is subject to due process. Wright v. Vinton Branch of the Mountain Trust Bank, 300 U.S. 440, 456-67 (1937); Kuehner v. Irving Trust Co., 299 U.S. 445, 451 (1937); Louisville Joint Stock Land Bank v. Radford, 295 U.S. 555, 589 (1935). *But see generally* Rogers, *supra* note 93.

property and contract tangents in the course of the due process analysis. Thus, the conclusion seems unavoidable that no constitutionally supportable argument can be made that lessors have property rights, not shared by secured parties, that place lessors, but not secured parties, beyond the power of bankruptcy to interfere. It seems, rather, that whatever the constitutional limits on bankruptcy's power over lienors,[199] the same limits apply when bankruptcy seeks to alter the state law rights of lessors.

The only suggestion that this is not the case comes from *Kuehner.* Lessors argued there that the limitation on their claim in bankruptcy treated them differently than creditors whose claims had no statutory ceiling. The Court countered as follows:

> The petitioners say that by limiting their claim they are put upon a different basis from other creditors. A sufficient ground for the distinction is that petitioners get back their property. In other words, they have lost merely a bargain for the use of real estate, whereas merchandise creditors, lenders, and others, recover in specie none of the property or money which passed from them to the debtor.[200]

This language could suggest that no interference with a lessor's right to the return of the leased property is permissible. Given the context of the case, however, a more accurate interpretation is that no issue concerning the scope of possible interference with the lessor's in rem rights was presented because the leased property was returned. The case, therefore, does not stand for the proposition that no interference with the lessor's rights in the residual of leased goods is constitutionally permissible.

The long-standing blurring of any distinction between contract and property rights, for constitutional purposes, lead the government to argue in *United States v. Security Industrial Bank*[201] that "for 'bankruptcy purposes' property interests are all but indistinguishable from contractual interests."[202] The government also argued that because "property" has been defined "sufficiently broadly to include rights which at common law would have been deemed contractual, traditional property rights are entitled to no

199. Professor Rogers argued that the only constitutional limitation on bankruptcy provisions is the bankruptcy clause itself. Rogers, *supra* note 93, at 977-97.

200. 299 U.S. at 455.

201. 459 U.S. 70 (1982). The issue in *Security Industrial Bank* was whether application of § 522(f)(2) to liens created before its passage in 1978 violated the Fifth Amendment. Under § 522(f)(2), a debtor can avoid a nonpossessory, nonpurchase money security interest in designated types of property (*e.g.*, household goods and furnishings, wearing apparel and jewelry held for personal use; tools of the trade; and health aids) to the extent that the lien impairs a bankruptcy exemption to which the debtor is entitled. If, for example, the debtor's car is worth $2500 and secures a debt of $2500, the debtor can avoid $1200 of the lien in order to enjoy the exemption provided (in a state that has not opted out of the federal exemptions) by § 522(b)(1) and (d)(2). Thus, the car would be sold and the debtor would take $1200 of the proceeds, leaving $1300 for the secured creditor. The secured creditor would have a $1200 unsecured claim as well.

202. United States v. Security Indus. Bank, 459 U.S. 70, 74 (1982).

greater protection under the Takings Clause than traditional contract rights."[203]

Although the Court made no constitutional holding[204] and the rights of lessors were not at issue, some of the Court's language may suggest that property rights and contract rights enjoy separate constitutional analysis:

> However 'bankruptcy principles' may speak to this question, our cases recognize, as did the common law, that the contractual right of a secured creditor to obtain repayment of his debt may be quite different in legal contemplation from the property right of the same creditor in the collateral. Compare *Hanover National Bank v. Moyses, supra* [186 U.S. 181 (1902)], with *Louisville Joint Stock Land Bank v. Radford, supra* [295 U.S. 555 (1935)].[205]

The Court also responded as follows to the government's argument that bankruptcy statutes are usually held applicable to pre-existing rights: "This statement is unobjectionable in the context of traditional contract rights, . . . but none of the cases cited by the Government extend it to property rights such as those involved here."[206]

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203. *Id.* at 75.

204. The Court found "substantial doubt whether the retroactive destruction of the appellees' [secured parties'] liens in this case comports with the Fifth Amendment," *id.* at 78, and, therefore, construed the provision to apply only prospectively to avoid the constitutional question.

Justice Blackmun, concurring in the judgment, stated that if the Court were writing on a clean slate he would reach the constitutional question and resolve it in favor of the debtor:

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

Id. at 84 (Blackmun, J., concurring in the judgment). Note that few of the reasons he listed for finding § 522(f)(2) constitutional when applied to avoid secured creditors' lien interests would apply to a provision avoiding a lessor's in rem rights in the residual value of the leased property and giving the lessor only a secured claim in the amount of the residual value. Such a provision is more likely to be constitutionally suspect. *Cf.* United States Trust Co. v. New Jersey, 431 U.S. 1, 19 (1977) (repeal of a covenant limiting the extent to which the Port Authority could subsidize rail passenger service from assets pledged as security for bonds "eliminated an important security provision and thus impaired the obligation of the States' contract.").

205. 459 U.S. at 75.

206. *Id.* at 80 (citation omitted) (footnote omitted).

Reading these statements to suggest that property rights and contract rights enjoy separate constitutional analysis might support the argument that property rights of lessors are constitutionally distinguishable from contract rights of lienors. The statutory provision at issue in the case, however, destroys the secured creditor's lien entirely, to the extent of its application, leaving the previously secured creditor with an unsecured claim against the estate. That constitutes "a complete destruction of the property right of the secured party"[207] and distinguishes the case from one in which the lessor's in rem rights are taken but recognition of their value is substituted.[208] *Security Industrial Bank* does not provide authority for the proposition that such treatment of a lessor is an unconstitutional taking of property without just compensation.

Since both lessors and lienors have property rights, and the Supreme Court has drawn no distinction between them,[209] the same constitutional (that is to say, due process) analysis applies to both parties. Thus, treating lessors in bankruptcy as secured parties are treated—by paying lessors the value of their residual in the leased goods, either in a lump sum or in a stream of payments having a value, as of the date of the plan, equal to the amount of the residual—would carry no constitutional infirmity.

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207. *Id.* at 75. In United States Trust Co. v. New Jersey, 431 U.S. 1, 26 (1977), the Court rejected the argument that a state may impair obligations without running afoul of the contracts clause as long as the state does not totally destroy them.

208. The Court in *Security Industrial Bank* distinguished cases in which "some but not all of the 'bundle of rights' which comprise the 'property' in question" were impaired. 459 U.S. at 76 (referring to Penn Cent. Transp. Co. v. New York City, 438 U.S. 104 (1978), which held that construction of an office tower on top of Grand Central Station could be barred by New York City's Landmarks Preservation Law).

Professor Rogers argued that analysis based on the extent of the destruction of property rights is circular, since it depends upon how the involved property rights are defined. Rogers, *supra* note 93, at 1019-20. Clearly, the distinction drawn in the text is less persuasive if the lessor's property rights are described as in rem rights to the leased goods.

209. The majority opinion in Allied Structural Steel Co. v. Spannaus, 438 U.S. 234 (1978), may be the leading counterpoint to this assertion. At issue in the case was a state statute requiring certain employers who close an office within the state to fund full pension benefits for all employees who had worked at least 10 years, thus increasing the employers' obligations beyond those imposed by their pension plans. The Court held that application of the statute violated the contract clause. In the course of reaching that holding, the majority stated that the contract clause imposes substantive limitations on the states' otherwise legitimate exercise of the police power. Justice Brennan, dissenting, suggested that the majority had inappropriately given contract rights more substantive protection than is accorded property rights:

> More fundamentally, the Court's distortion of the meaning of the Contract Clause creates anomalies of its own and threatens to undermine the jurisprudence of property rights developed over the last 40 years. . . . There is nothing sacrosanct about expectations rooted in contract that justify according them a constitutional immunity denied other property rights.

Id. at 259, 261 (Brennan, J., dissenting). Justice Brennan's dissent, by proceeding to a discussion of the statute's constitutionality under the due process clause, despite the fact that appellant had raised only the contract clause question, provides another example of an issue presented in contract terms devolving into a question of due process.

IV. Conclusion

The underlying premise of this Article is that a lease of equipment and a security interest in equipment are so similar in functional terms that bankruptcy's different treatment of the two devices is not justified. Granted, if lessors were treated more like holders of secured claims, lessors would no longer be able to force the return of leased equipment upon expiration of the lease term. Instead, giving them a secured claim in an amount equal to the value of the equipment's residual as of that time, plus an unsecured claim for contractual damages, would be fully compensatory.[210]

That should have no negative impact on a lessor, beyond the usual risks of the valuation process itself, except in one instance—a rising market. If the equipment is increasing in value, the lessor who can enforce in rem rights to the residual can capture the increased value; if the lessor is simply given a secured claim in the amount of the equipment's residual value as of a particular time, any increase in value after that time will be captured by the estate. Thus, the issue is one of determining which party will enjoy the upswing. Assigning the upswing in value to the estate would serve the bankruptcy policy of encouraging rehabilitation.[211] That potentially detrimental outcome (from the lessor's point of view) would be unusual in the case of equipment, however, which typically depreciates rather than appreciates. Confining unitary treatment to the equipment context, therefore, would reduce the likelihood that this eventuality would come to pass. Even in the unusual case of appreciation, however, capturing the upswing for the estate rather than for the lessor arguably is not so bad. After all, that is exactly what happens to secured parties.

The argument presented here is not as dramatic as it may first appear. Although it would make lease assumption a type of avoiding power,[212] the argument essentially is that a line already drawn by bankruptcy, in distinguishing between true leases and security leases, should merely be drawn somewhere else.[213] Moreover, the 1978 Code eliminated effective use of ipso

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210. Payments for use pending the decision to cash out the lessor, which were a factor in *Blaisdell, Radford,* and *Vinton,* are less clear. Such payments would be very similar to compensation for lost opportunity costs, but secured parties are not entitled to such compensation according to United Sav. Assoc. v. Timbers of Inwood Forest Assocs., Ltd., 484 U.S. 365 (1988). (See the discussion of the case in text at note 30, *supra.*) Thus, lessors probably should not be compensated for such use either.

211. The Code already captures for the estate the upswing in value during the term of the lease, thereby treating secured parties and lessors alike. Thus, if similar equipment is currently leasing for more than the lease price, the lessor cannot exercise a termination-at-will clause postbankruptcy in order to recover the property and re-lease it at the higher price. Under current law, however, the lessor, unlike the secured party, captures the upswing in the residual.

212. Professor Andrew condemned such "avoiding power" and "title-clearing" in the context of rejection of executory contracts. Andrew, *supra* note 6, at 901-31.

213. *Cf. In re* Moreggia & Sons, Inc., 852 F.2d 1179 (9th Cir. 1988), which held that even though an agreement is a lease under state law, it is not a lease within § 365(d)(4); that provision is to be interpreted under federal law.

facto clauses and this proposal, arguably, just takes another step down that road.

This unitary treatment should not be without limit, however. Just as secured parties are caught in bankruptcy only if their collateral is necessary for an effective reorganization,[214] the lessee should not be able to impose on a lessor treatment similar to that given a secured party unless the leased equipment is necessary to the reorganization effort. This ought to eliminate short-term leases that involve an insignificant portion of the property's economically useful life.

The underlying premise itself (that equipment leases and security interests in equipment are functionally similar) provides another limitation—that is, that different treatment in bankruptcy is justified when substantial functional differences exist in fact. The lease-security interest distinction may, historically, have been a fairly accurate proxy for transactions that carried functional distinctions justifying different treatment in law because only leases of realty were contemplated.[215] Originally, the lease-security interest distinction mirrored the realty-personalty distinction, and both captured those transactions in which return of the property is the essence of the deal—so essential to it, in fact, that the lessor-transferor would never have entered into that deal if he had thought that the property might not ultimately be returned. When return of the property is so central, the case for functional economic similarity is substantially weakened, and a readjustment of rights in accordance with the argument presented in this Article might not pass constitutional muster.

In several types of leases, such as those applicable to unique goods[216] or for short terms, return of the property might be essential to the trans-

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214. Section 362(d)(2)(B) gives a secured creditor a right to relief from the automatic stay if the property is not necessary to an effective reorganization (if, in addition, the debtor has no equity in the property).

215. Section 365 itself may be in part explained by the special place of real estate interests under the law. Leasing of personalty has acquired commercial significance only recently. Thus, the special treatment of leases in bankruptcy may be rooted in the fact that real estate, historically, was the usual subject of leases.

Provisions governing the assumption and rejection of leases and executory contracts were first enacted in the 1930s. Section 70b, which applied in "straight bankruptcy," was limited to leases of real estate. Chandler Act, ch. 575, § 70b, 52 Stat. 840, 880-81 (1938). Interestingly, the provision governing corporate reorganization was not limited by its terms to leases of real estate. As enacted, it provided that a plan of reorganization could reject executory contracts, "including unexpired leases." Section 77B(b)(6), ch. 424, 48 Stat. 911, 914 (1934). At the time of its repeal in 1978, the Bankruptcy Act's corporate reorganization provisions made no reference to unexpired leases. They simply allowed the plan (or arrangement, in the case of Chapter XI) to provide for the rejection of "any executory contract." Bankruptcy Act of 1898, §§ 216(4) & 357(2), 11 U.S.C. §§ 616(4) & 757(2), *repealed by* Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 (codified as amended at 11 U.S.C. §§ 101-1330 (1988)).

216. On the assumption that compensation cannot adequately be determined for any unique property leased to the debtor, then the treatment recommended in this Article should be limited to non-unique equipment.

action. Real estate, however, continues to present the most compelling example. Several reasons justify drawing a distinction between personal property and real property leases in the context of this Article. First, real estate truly "has mystical connotations in our legal system"[217] and is surrounded by special rules. Section 365 currently carves out certain real estate transactions for special treatment[218] on the justification that the equities balance out differently for nonbankrupt parties with particular types of interests in real estate.[219] Secondly, real estate transactions typically

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217. Johnson, *supra* note 99, at 751.

218. Section 365(b)(3) governs adequate assurance of future performance in the context of a lease of premises in a shopping center. It requires assurance of source of rents, percentage rents, compliance with master leases, and tenant mix.

Section 365(d)(3), which was added in 1984, requires the trustee to perform all obligations under a lease of nonresidential real property (other than those related to solvency and financial condition) between the commencement of the case and the decision to assume or reject. Although the provision is not limited by its terms to leases in shopping centers, such legislative history as there is indicates a congressional concern with the impact on solvent tenants in shopping centers of a long-term vacancy or partial operation by a bankrupt tenant. 130 CONG. REC. S8894 (June 29, 1984).

Section 365(d)(4) applies to leases of nonresidential real property, under which the debtor is lessee in a case under any chapter, and provides that the lease is deemed rejected unless the trustee assumes or rejects within 60 days. Like subsection (d)(3), § 365(d)(4) was added in 1984 and is often referred to as one of the "shopping center amendments."

Sections 365(h), (i) and (j) provide protection, in the nature of a specific performance remedy, for certain possessory interests in real property. Under subsection (h), if the debtor is lessor or seller of a timeshare interest under a timeshare plan and the agreement is rejected, then the nondebtor can choose to treat the agreement as terminated or to remain in possession for the balance of the term. If the latter course is chosen, the nondebtor may offset against money owed under the agreement any damages resulting thereafter from the debtor's nonperformance. Subsection (i) applies when the debtor is a seller of real property or of a timeshare interest. In that case, the purchaser may treat the agreement as terminated or may remain in possession and continue to make the required payments, again offsetting damages resulting thereafter from the debtor's nonperformance. If the nondebtor chooses to treat the agreement as terminated, or if the purchaser under a rejected contract for the sale of real estate is not in possession of the premises, then subsection (j) gives the nondebtor a lien on the property for the amount already paid.

219. *See supra* note 218. All three of these subsections were designed to prevent the nondebtor from being "deprived of his estate for the term for which he bargained." SENATE REPORT, *supra* note 32, at 5846; HOUSE REPORT, *supra* note 94, at 6306.

Additional provisions singling out real estate interests were added to § 365 in 1984 by the Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, 98 Stat. 333 (codified as amended in various sections of 11 U.S.C. and 28 U.S.C.). Although the 1984 amendments were not accompanied by a committee report, the available legislative history notes the "unique problems" faced by nonbankrupt shopping center lessors and tenants when one of the other tenants files bankruptcy. 130 CONG. REC. S8891 (June 29, 1984) (statement of Sen. Hatch on H.R. 5174), 98th Cong., 2d Sess., *reprinted in* 1984 U.S. CODE CONG. & ADMIN. NEWS 590, 591. Senator Hatch focused on the shopping center context:

> Approximately half of all U.S. retail trade is conducted in shopping centers. Retail merchants in shopping centers depend upon the operation of a carefully chosen mix of stores, all contributing to the success of the entire shopping center. If shopping center tenants[,] especially major tenants, are not operating their stores, are not paying charges necessary for the upkeep of the shopping center or are using their

involve larger amounts of money and longer terms than equipment transactions. These factors are relevant because they reveal differences in the expectations of the parties. Although bankruptcy is in the business of disregarding expectations, too wholesale a disregard of the expectations of nondebtor parties may have unexpected consequences on their commercial behavior.[220] Thirdly, because real estate transactions involve an asset that is most often stable or increasing in value, the residual involved is of a fundamentally different nature. Unlike equipment, real property has a significant value at the end of a lease, regardless of the length of its term.[221] The bankruptcy treatment recommended in this Article essentially constitutes forced sale of the leased property. This goes further than allowing the debtor to capture the upswing in value of the property, which bankruptcy already permits in other contexts.[222] It carries a substantial risk of under-

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> space in ways not provided for in the lease and which disrupt the tenant mix, the financial health of all the other merchants and of the shopping center itself can be threatened. This bill will reduce the likelihood that provisions of the bankruptcy code will themselves add to the economic distress of retail merchants in shopping centers.

Id. at 600-01. While the justification for the provisions added in 1984—§ 365(d)(3) & (d)(4)—rested on the special situation of shopping center lessors and tenants, the provisions themselves refer to nonresidential real property and, therefore, have a broader applicability than just shopping centers. *Cf. In re* Hejco, Inc., 87 Bankr. 80 (Bankr. D. Neb. 1988) (holding that § 365(d)(4) contemplates only two classes of real property—residential and nonresidential; agricultural land is nonresidential real property and therefore is governed by that subsection). The only provision in § 365 that explicitly refers to shopping centers—subsection 365(b)(3)—has been part of the Code since 1978. The legislative history indicates merely that it is based upon the need of shopping center lessors for "protection" when a bankrupt lessor assumes the lease. SENATE REPORT, *supra* note 32, at 5844-45.

220. Real estate leasing differs from equipment leasing in that real estate lessors typically retain substantial incidents of property, including rights of control over the premises. Most commercial real estate leases are space leases, rather than ground leases, and the interests of other lessees in the shopping center or office building are involved. While a long-term ground lease under which the lessee has extensive rights of control over the premises (such as rights to demolish improvements or to change use) might begin to resemble equipment leases in economic terms, problems in valuing the residual in the more typical real estate lease would be insurmountable. Thus, real estate leases should not be subjected to the bankruptcy treatment recommended here for equipment leases.

221. Professor Kripke argued that chattel security, accounting, and tax laws have fundamentally erred by determining rights on the basis of whether the residual in personalty is nominal:

> The fact is that the residual at the end of an eight, ten, or fifteen-year lease of equipment has so little present value at the inception of the lease, particularly when discounted in light of today's interest rates, that it can make no sense for any determinations for legal, accounting, or tax purposes to turn on characterization of its ultimate value at the end of the lease.

Kripke, *supra* note 95, at 728.

222. Valuation of collateral, which is so critical in bankruptcy cases, provides one example. Valuation freezes the amount that a secured creditor is entitled to get as of the time of valuation, even though the collateral is expected to appreciate at some future time. *See, e.g., In re* BBT, 11 Bankr. 224 (Bankr. D. Nev. 1981).

Another example comes from § 506(d), which most courts read to permit the debtor to compensation of the nonbankrupt party's interest. To impose this risk upon a party that leased real property (expecting to get it back at the end of the term) rather than having entered into some sort of sales transaction (expecting eventual loss of ownership) is so great and fundamental an interference with rights and expectations that it cannot be justified on the usual grounds of bankruptcy policy—encouraging rehabilitation of the debtor. Finally, the nonbankrupt party's attitude toward "his" property is probably different in real estate cases than in equipment cases[223] due to the uniqueness of the property that is the subject of the lease, and the likelihood that leased equipment is tailored to the debtor's needs and that the lessor may have no particular use for it otherwise.

Thus, even though nonequipment leases can substantially mimic lien transactions, this Article's argument is limited, intentionally, to the equipment context. And the point is simply that nothing in the nature of the interests of equipment lessors and secured parties justifies the difference in treatment bankruptcy accords them. If other arguments justify it,[224] the focus should be there.

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avoid liens to the extent they are not supported by value in the collateral, to pay the creditor the amount of the remaining lien, and to keep the collateral, including appreciation, free of the creditor's claims. Gaglia v. First Fed. Sav. & Loan Ass'n, 889 F.2d 1304 (3d Cir. 1989). *But see*, Dewsnup v. Timm (*In re* Dewsnup), 908 F.2d 588 (10th Cir. 1990), petition for cert. filed, no. 90-741 (Nov. 11, 1990).

Finally, the debtor keeps any appreciation of property that is exempted.

223. *See supra* notes 146 & 147.

224. The argument that bankruptcy should follow state law entitlements for reasons of strategic selection might justify continued differential treatment of lessors and secured parties. Dean Jackson argue that bankruptcy should follow state law rules in order to reduce the strategic use of bankruptcy. T. JACKSON, *supra* note 14, at 21-27. (Strategic use is unavoidable to some extent, of course, or there is no bankruptcy. In order to have a bankruptcy system, some of the rules have to be different in bankruptcy than outside of it; thus, the question is only where to fix the line.) One should, however, take into account the cost to the system of utilizing irrational state law constructs such as whether a particular transaction constituted a secured transaction or a lease. A great number of bankruptcy cases are concerned with whether an agreement *is* a lease, and thus not within Article 9. The cost savings that would be enjoyed by eliminating that litigation must be compared with the effect that abandoning state law characterizations would have on strategic behavior. Furthermore, following such state law rules imports into bankruptcy any negative aspects those rules have in the nonbankruptcy sphere.

For a discussion of whether bankruptcy should follow state law distributive rules, in the larger context of general bankruptcy policy, see the debate between Professors Baird and Warren. Baird, *Loss Distribution, Forum Shopping, and Bankruptcy: A Reply to Warren*, 54 U. CHI. L. REV. 815 (1987); Warren, *Bankruptcy Policy*, 54 U. CHI. L. REV. 775 (1987).