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THE EFFECT OF REORGANIZATION PROCEEDINGS ON SECURITY INTERESTS: THE POSITION UNDER ENGLISH AND U.S. LAW

Nick Segal[*]

I. INTRODUCTION

This Article outlines the laws regulating the position of secured creditors in both English (administration) and U.S. (Chapter 11) reorganization proceedings. It does so by identifying six core issues that define the position of a secured creditor in such proceedings, and by considering the English and U.S. approaches to each issue. By placing the analysis of the English and U.S. reorganization rules side by side, I have sought to adopt a comparative study in order to allow the similarities and differences of each system's approach to be clearly seen.[1]

As an initial matter, the power to appoint a receiver, and on occasions an administrative receiver, over substantially the whole of the debtor's property remains a distinguishing feature of English law. Despite the general abolition of the right to appoint administrative receivers, the ability to make such appointments continues in a number of significant respects—first, in relation to security agreements created before September 15, 2003, many of which will continue in operation for many years; and second, because of a number of significant exceptions to the abolition of administrative receivership. Furthermore, both as a matter of law and practice, the ability to appoint other types of receiver (where the appointment is not over the whole, or substantially the whole, of the debtor's property) gives secured creditors rights, and a range of practical options, that distinguish the English law position from that in the United States. This is of particular practical significance because enforcement rights in relation to security interests over cash and financial instruments (as defined by the Financial Collateral Arrangements (No. 2) Regulations 2003[2]) are unaffected by the commencement of an administration. Having said that, in the United Kingdom administration is increasingly used in preference to administrative receivership unless there is some particu-

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1. For an excellent general comparative treatment of U.S. and English secured credit law, see GERARD MCCORMACK, SECURED CREDIT UNDER ENGLISH AND AMERICAN LAW (2004). *See also* PHILIP WOOD, PRINCIPLES OF INTERNATIONAL INSOLVENCY, Chapter 14 (2d ed. 2007).

2. Financial Collateral Arrangements (No.2) Regulations, 2003, S.I. 2003/3226 (Eng.).

lar reason justifying the use of receivership. To this extent, the landscape in the United Kingdom will increasingly reflect that in the United States, insofar as a collective reorganization proceeding will be the bankruptcy proceeding of choice when large debtors get in to financial difficulty.

Nevertheless, there remains a substantial and fundamental difference between the nature and scope of Chapter 11 proceedings and administrations.[3] Administrations can ultimately have only a limited effect on the position of secured creditors—certainly on such creditor's right to enforce their security (although the English courts have yet to explore the limits of this principle). The position in Chapter 11 is very different, principally because of the wide power to cram down secured creditors contained in section 1129(b)(2)(A) of the Bankruptcy Code. Furthermore, because of the court-focused and court-driven nature of Chapter 11 proceedings, secured creditors are required to participate in a court-managed proceeding which is designed to give all stakeholders negotiating leverage. Therefore, even though granted substantial protections by the Bankruptcy Code,[4] secured creditors are required actively to justify and argue for the protection of their rights.

However, while the protections and wide powers given to the debtor in Chapter 11 proceedings, along with the continuous involvement of activist bankruptcy courts, create the conditions for a strong debtor lead procedure, the Chapter 11 process has seen a number of significant changes in recent years, some of which are driven by law reform and some by market developments. Some bemoan but others applaud the fact that it is no longer the force it once was. Amendments to the Bankruptcy Code, made over a decade ago, have given added protections to certain classes

3. For a useful recent comparison between English corporate rescue and Chapter 11 proceedings, see ROY GOODE, PRINCIPLES OF CORPORATE INSOLVENCY LAW 327–28 (3d ed. 2005).

4. There are essentially three basic policies that underlie the treatment of secured creditors under Chapter 11. First, they are entitled to either the collateral or its full value. Second, for the benefit of their debtor or other creditors who might be injured by the repossession of their collateral, they may be required to wait for that to which they are entitled. Third, if secured creditors are required to wait they may be "adequately protected" against loss during their wait. There remains a fundamental policy difference between the English and the U.S. systems. The secured creditor's interest in the collateral is commandeered by the bankruptcy system primarily to prevent two kinds of losses. First, a repossession might force the closing of a business that could otherwise generate enough income to pay not only the secured creditors but other creditors as well. Second, permitting a necessary liquidation of the debtor's assets to go forward in the state courts may result in a windfall to the purchaser at the foreclosure sale and the loss of equity in the property that could have been realized through a commercially reasonable bankruptcy sale for the debtor or other creditors. *See* LYNN LOPUCKI & CHRISTOPHER MIRICK, STRATEGIES FOR CREDITORS IN BANKRUPTCY PROCEEDINGS 535–638 (4th ed. 2003).

of creditors—labeled by critics of the reforms as "special interest groups"—including some secured lenders such as aircraft financiers. Additionally, the creditor-friendly changes introduced by the 2005 reforms[5] have improved the position of various creditors and weakened the leverage of the debtor.

These changes can be seen as compounding the trend of increasing creditor control, including secured creditor control. The use of tight covenants in post-petition financing documentation, as well as the appointment of chief restructuring officers at the instigation of creditors early in the Chapter 11 proceeding to support or replace existing management are two examples. Furthermore, the increase in the number of cases in which the debtor's business is sold during the Chapter 11 proceeding, resulting in proceeds of sale to be distributed to secured and other creditors, has altered the Chapter 11 dynamic and landscape. Similarly, the increasing number of pre-packaged or pre-negotiated reorganization plans (where plan terms are agreed to before the filing) have also had an impact.[6] However, it is also worth noting that the uncertainties over judicial valuations in contested Chapter 11 plans has resulted in the weakening of the bargaining position and priority of such senior creditors.[7]

The automatic stay resulting from the commencement of either a Chapter 11 or an administration proceeding are broadly similar as they relate to secured creditors. Still, the ambit of the Chapter 11 stay is clearly wider in a number respects. In particular, it protects the debtor from informal acts to recover pre-petition claims. Additionally, while both jurisdictions allow secured creditors relief from the automatic stay on broadly similar grounds, the adequate protection doctrine is more clearly articulated under the Bankruptcy Code. There is a point of general significance to be noted here, namely that the Bankruptcy Code tends to deal in depth and detail with important core doctrines, while the Insolvency Act, 1986[8] tends to create broad judicial discretions. Take for example the broad discretion to grant leave to take steps to enforce security, without any statutory explanation as to how the discretion should be exercised, which

5. Bankruptcy Abuse Prevention and Consumer Protection Act, Pub. L. No. 109-8, 119 Stat. 23 (2005) (codified as amended at 11 U.S.C. § 101 (2007)).

6. *See* Harvey R. Miller & Shai Y. Waisman, *Does Chapter 11 Reorganization Remain a Viable Option for Distressed Businesses for the Twenty-First Century?*, 78 AM. BANKR. L.J. 153, 166 (2004).

7. *See* Douglas G. Baird & Donald S. Bernstein, *Absolute Priority, Valuation Uncertainty, and the Reorganization Bargain*, 115 YALE L.J. 1930 (2006).

8. Insolvency Act, 1986, c. 45 (Eng.).

leaves it to the English judges to fill in the gaps in light of the purpose of the relevant statutory provisions.[9]

English and U.S. law also differ in the protection each grants to a secured creditor's rights. While the Bankruptcy Code grants special protection to a secured creditor's rights in cash collateral, the English system grants, on the one hand, more protection in respect of security over "financial collateral" covered by the Financial Collateral Arrangements (No. 2) Regulations 2003 (because the moratorium which arises on an administration is disapplied) and, on the other hand, less protection because following the *In re Spectrum* decision,[10] the proceeds of receivables in English law are likely to be subject only to a floating charge and available to the administrator to use without having to satisfy an adequate protection test.

Additionally, English law respects the after-acquired property clause in winding-up and administration proceedings to a greater extent than applicable U.S. law. However, the practical significance of the differences between the two systems is limited. In administrations, where an asset is acquired after the commencement of the administration, it is necessary to ask whether it represents property of the debtor which directly or indirectly represents floating charge property disposed of by the administrator. Where it does, the secured creditor is treated as continuing to have a floating charge over the asset. If the after-acquired property is not property directly or indirectly representing floating charge property disposed of, and falls within the description of property covered by the fixed charge, then it continues to be subject to the fixed charge. Under U.S. law, if the after-acquired property represents proceeds of collateral subject to the pre-petition security interest, a security interest continues to attach unless the bankruptcy court orders otherwise "based on the equities of the case." Where the Chapter 11 debtor produces a new product after the commencement of the case, and the materials consumed in the manufacturing process are subject to the lender's pre-petition security interest, the bankruptcy court usually has no basis for invoking its equitable power to limit the security interest, so the security interest will continue. This is the same position which applies to the proceeds of floating charge property in an English administration. However, where a post-

9. This difference in approach can also be seen in the context of reorganization plans that allow the variation or discharge of the rights of creditors, including secured creditors. In England, the entire statutory regime dealing with schemes of arrangement is only three sections long and most of the law (including the rules regulating the limits of majority voting power) is judge made. This approach may be difficult to sustain in the face of increasing numbers of contentious and contested schemes involving bondholders.

10. *In re* Spectrum Plus Ltd. [2005] 2 A.C. 680 (H.L.).

petition product is made using assets or cash not previously subject to the lender's security interest, the new product will not be subject to the lender's lien. This is different from the position in an English administration, although, arguably, the position is the same in an English winding up which divests the debtor of the beneficial interest its property.[11] It is at least arguable that upon the commencement of the winding up, such assets become subject to a statutory trust so that products created therefrom or their proceeds are not property of the debtor to which the security interest can attach.

In an English administration, the debtor has the power to "dispose of or take action relating to" floating charge property, which, in the post-*Spectrum* world, can often be expected to include receivables and book debts, without the need for a court order or permission from the secured creditor. In a Chapter 11 proceeding, there is a distinction made between cash collateral and non-cash collateral. Unless the secured creditor consents to the use of the cash collateral by the debtor, it may not be used unless the court is satisfied that the secured party's interest is adequately protected. The debtor may, however, use, sell, or lease non-cash collateral in the ordinary course of its business without obtaining court approval. If a lender is concerned about his position, he needs to file a request with the court for adequate protection.

In an English administration, the secured creditor will find that his floating charge security interest is subordinated to the costs and expenses of the administration, while his fixed charge is not subject to such costs and expenses. However, in a Chapter 11 proceeding, the secured creditor is always subject to the risk of a surcharge because the Bankruptcy Code permits the debtor to recover administrative expenses from a secured creditor's collateral where they are necessary to preserve or dispose of the collateral, are reasonable, and provide a benefit to the secured creditor. Furthermore, one of the conditions to the confirmation of a plan of reorganization is that the holder of administrative expense claims will be paid in full in cash so that a secured lender can find that his rights have been changed by the plan despite his opposition (as a result of the cram down provisions)[12] and that the administrative expenses of the Chapter 11 case are paid in full on the effective date of the Chapter 11 plan. Furthermore, the secured creditor's pre-petition security interest could be primed and subordinated to new security granted in respect of post-

11. *See* Ayerst v. C. & K. (Construction) Ltd., [1976] A.C. 167 (H.L.).

12. Perhaps he has been forced to accept the indubitable equivalent of his pre-petition security interest.

petition financing, where the pre-petition secured creditor's security interest is adequately protected.

As already noted, there is a very substantial difference between English and U.S. law in relation to majority voting and cram-down—that is, the ability to vary or discharge the rights of secured creditors without the consent of each affected creditor. In England, in an administration and company voluntary arrangement (CVA), the secured creditor's right to enforce his security is entrenched and cannot be prejudiced by the administrator's proposals or the terms of the CVA, without the consent of the secured creditor. No such protection arises with respect to schemes of arrangement.[13] However, English law does not have a true equivalent to the cram-down that arises in Chapter 11 proceedings. There is no ability to impose a plan on a class of impaired creditors who are made a party to a scheme of arrangement without the consent of the class as a whole. If the class votes to approve the scheme by the requisite majority, each member of the class may be bound. However, Chapter 11 allows, subject to satisfying the cram-down criteria contained in section 1129(b) of the Bankruptcy Code, an impaired class to be bound by the plan even though the class as a whole has voted against the plan.[14] It is true that the English courts have added their own gloss to the statutory provisions dealing with schemes by holding that where a class of creditors have no economic interest in the debtor, they need not be consulted and their votes on the scheme can be disregarded.[15] Furthermore, the test for determining whether or not a class of creditors has an economic interest has been held to be what the relevant class would receive in the event that the debtor was wound up and the assets sold and distributed in a liquidation.[16] This approach is controversial. First, there is currently a controversy as to the basis on which the debtor's assets should be valued for determining whether a class of creditors has an economic interest. The approach to valuation questions adopted in Chapter 11 proceedings for

13. A class of secured creditors could have their rights varied pursuant to a scheme of arrangement to which the class was a party if seventy-five percent in value and a majority in number of the class voted in favor of the scheme and the court sanctioned it.

14. Note that it is also not necessary for the impaired class actually to vote on the plan. While it is necessary that a least one other impaired class of creditors has voted in favor of the plan, where a class is totally impaired and the plan provides that members of that class will not receive or retain any property under the plan on account of their claims, the class is deemed to reject the plan. Where an impaired class needs to be crammed-down, the absolute priority rule is triggered and the plan may be confirmed over the opposition of an impaired class if the plan does not discriminate unfairly, and is fair and equitable. *See* 11 U.S.C § 1129(b)(1).

15. *See In re* MyTravel Group Plc., [2005] 1 W.L.R. 2365 (C.A.).

16. *See id.* at 2386–88.

the purpose of testing whether a Chapter 11 plan is consistent with the absolute priority rule has been prayed in aid by junior classes of creditors who wish to have the debtor's business valued on the basis of a going concern enterprise value. In addition, there is some uncertainty as to the legal basis for the rule that allows the court to disregard classes of creditors with no economic interest. The statutory provisions in the Companies Act of 1985[17] include no such power. Insofar as the court is exercising its discretion at the required hearing to sanction a scheme of arrangement approved by the requisite majorities of creditors, there seems to be a proper basis for considering whether creditors who have not been made a party to the scheme, and who receive no benefits thereunder, have been fairly treated and a test based on the absence of an economic interest in the estate makes sense. However, it seems more difficult to justify a rule that allows the court to impose the plan on a class of creditors who have been made a party to the scheme and voted against it.

There are, in addition, differences between the rules in the United States and England governing the circumstances in which pre-bankruptcy secured transactions can be set aside as fraudulent transfers, preferences, or transactions at an undervalue. I have not, however, considered these differences (partly because I primarily wanted to pay attention primarily to the way in which secured creditors participate in Chapter 11 and administration proceedings).

I have focused on the operation and effect of the administration and Chapter 11 regimes as they relate to secured creditors and not sought to address the wider debate concerning the policy and principle justifications for the treatment of secured creditors under each system. There is, of course, extensive literature, mainly in the United States, on policy justifications for priority given to secured creditors.[18]

II. THE ENGLISH LAW BACKGROUND—RECENT DEVELOPMENTS AND THE DISTINCTION BETWEEN FIXED AND FLOATING CHARGES

The secured creditor, particularly the secured creditor holding security interests over the whole, or substantially the whole, of the debtor's prop-

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17. Companies Act, 1985, c. 6 (Eng.).

18. For a useful collection of U.S. materials, see BARRY E. ADLER, FOUNDATIONS OF BANKRUPTCY LAW 23–54 (2005); *see also* Jay Lawrence Westbrook, *The Control of Wealth in Bankruptcy*, 82 TEX. L. REV. 795 (2004) (containing useful comparative material and a discussion of the English and U.S. regimes). For an English perspective and excellent citation of the literature in the United States and England, see RIZWAAN JAMEEL MOKAL, CORPORATE INSOLVENCY LAW: THEORY AND APPLICATION 133–87 (2005).

erty,[19] has traditionally enjoyed great freedom of action under English law. For example, the secured creditor has had the benefit of a wide range of contractually defined and self-help remedies which were capable of being exercised without the involvement of a court, and which remained exercisable even after the commencement of reorganisation proceedings. In England, the reorganization proceeding is the administration procedure (which, unlike its U.S. counterpart—Chapter 11 of the Bankruptcy Code—can normally only be commenced upon a finding or declaration that the debtor is, or is likely to become, insolvent).[20]

However, there have been a number of significant changes in English law in recent years that have impacted the secured creditor's position in an administration proceeding.[21] Three are particularly noteworthy: (1) the Enterprise Act 2002;[22] (2) the Financial Collateral Arrangements (No.2) Regulations 2003 (implementing the E.U. Collateral Directive); and (3) the House of Lords judgment in *In re Spectrum Plus Ltd*.[23]

A. The Enterprise Act

The Enterprise Act has qualified and significantly reduced the ability of a secured creditor both to enforce its security interest following the

19. A key concept of English insolvency law after 1986 is that of the administrative receiver. An administrative receiver is "a receiver or manager of the whole (or substantially the whole) of a company's property appointed by or on behalf of the holders of any debentures of the company secured by a charge which, as created, was a floating charge, or by such a charge and one or more other securities." Insolvency Act, 1986, ch. 45, § 29(2). In order to have the full protection and benefit of English insolvency law, a secured creditor needs to have an asset security which gives it the right to appoint an administrative receiver. The term "qualifying floating charge" is also important in this context and means: "a floating charge . . . created by an instrument which . . . purports to empower the holder of the floating charge to appoint an administrator of the company, [or] purports to empower the holder of the floating charge to make an appointment which would be the appointment of an administrative receiver." *Id.* c. 45, Schedule B1, para. 14(2).

20. There is, however no requirement of actual or impending insolvency in relation to an out of court appointment of an administrator by the holder by a qualifying floating charge.

21. It is also worth noting, by way of introduction, that there has been extensive pressure for the reform of the English law of security interests. A series of substantial reports have been prepared—for example, by the Company Law Steering Group and the Law Commission—recommending changes to the English system, including a change to a notice filing system. *See, e.g.*, LAW COMMISSION, PUBL'N NO. 296, COMPANY SECURITY INTERESTS (2005) (Eng.). To date however, the Government has refused to implement the proposed changes.

22. Enterprise Act, 2002, c. 40.

23. *In re* Spectrum Plus Ltd. [2005] 2 A.C. 680 (H.L.).

commencement of an administration proceeding and to block the commencement of such a proceeding. However, such secured creditors retain a privileged and strong position within the administration proceeding.[24]

B. The Financial Collateral Arrangements (No.2) Regulations 2003

The Financial Collateral Arrangements (No.2) Regulations have improved the position of secured creditors where they have security over the types of collateral covered by the Regulations[25]—cash or financial instruments including shares, bonds, and any other securities which are "normally dealt in" and which give the right to acquire such shares or bonds.[26] The Regulations disapply certain provisions of the administration proceeding regime, including the moratorium on the enforcement of security, the ability of the administrator to deal with financial instruments subject to fixed and floating charge security, as well as some of the claw-back provisions that are triggered by the commencement of an administration. However, transaction at an undervalue and preference rules still apply.

C. The Spectrum *decision*

While the Regulations represent a positive development for secured creditors, the House of Lords decision in *In re Spectrum* represents a retreat and reduction in their protection in administration proceedings. While the precise impact of the decision remains to be established, for

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24. *See infra* Part III.A.1 (discussing how secured creditors retain a privileged and strong position within the administration proceeding).

25. Note that one of the requirements that needs to be satisfied for the Regulations to apply is that the collateral must be in the possession or under the control of the collateral-taker. The Regulations are, however, silent as to what constitutes possession or control in this context. It is unclear whether an equitable charge or a floating charge (certainly before crystallization) are covered. Note also that, the Regulations provide that the right of a collateral-provider to substitute equivalent financial collateral or to remove excess financial collateral will not prevent the financial collateral being in the possession or under the control of the collateral taker. *See* GEOFFREY FULLER, CORPORATE BORROWING: LAW AND PRACTICE 78–80 (3d ed. 2006).

26. The ambit of the definition of "financial instruments" is wide, covering:

> (a) shares in companies and other securities equivalent to shares in companies; (b) bonds and other forms of instruments giving rise to or acknowledging indebtedness if these are tradable on the capital market; and (c) any other securities which are normally dealt in and which give the right to acquire any such shares, bonds, instruments or other securities by subscription, purchase or exchange or which give rise to a cash settlement (excluding instruments of payment).

Financial Collateral Arrangements (No.2) Regulations 2003, § 3.

present purposes it can be taken to establish the rule that most security interests over debts and receivables will be treated as floating, and not fixed, charges. This has a significant impact in relation to administration since an administrator has the ability to "dispose of or take action relating to property which is subject to a floating charge as if it were not subject to the charge."[27] However, where property is disposed of by the administrator, the floating charge holder has the same priority over acquired property as he had over the disposed property. The combination of this provision of the Enterprise Act and the *In re Spectrum* decision means that in many cases, administrators will now have access to funds to cover the costs of the administration without the need to obtain the consent of the secured creditor. This is an area in which the secured creditor in the United States has a stronger position than his counterpart in England. Under the Bankruptcy Code, the debtor "may not use, sell, or lease cash collateral . . . unless each entity that has an interest in such cash collateral consents," or the court grants permission based on its satisfaction that the debtor has provided adequate protection of the secured creditor's interest.[28]

D. Fixed and Floating Security Interests

In order to understand the impact of bankruptcy proceedings on security interests under English law, it is necessary to take account of the crucial distinction between fixed and floating security interests. Charges[29] may be fixed or floating. A fixed charge is one which attaches as soon as the charge has been created, or the debtor has acquired rights in the asset to be charged, whichever is the later. The effect of this is that the debtor cannot dispose of the asset free from the charge without the chargee's consent except by satisfying the indebtedness secured by the charge. The floating charge, by contrast, is one which hovers over a designated class

27. Insolvency Act, 1986, c. 45, Schedule B1, para. 70(1).
28. 11 U.S.C. § 363(c)(2) (2007).
29. The term "charge" is used in this Article as a general description of security interests under English law. While the terms "charge" and "mortgage" are often used interchangeably, there is technically an important distinction between the two concepts. A mortgage is a transfer of ownership to the creditor by way of security upon the express or implied condition that the asset shall be reconveyed to the debtor when the sum secured has been paid. An equitable charge, however, does not involve the transfer either of possession or of ownership, but constitutes the right of the creditor, created either by trust or by contract, to have a designated asset of the debtor appropriated to the discharge of the indebtedness. The right is satisfied out of the proceeds of sale of the asset, where the sale results from the debtor's voluntary act or takes place under a court order for sale or the appointment of the receiver made on application of the chargee. *See* ROY GOODE, COMMERCIAL LAW 586–87 (3d ed. 2004).

of assets in which the debtor has or will in the future acquire an interest. The debtor has liberty to deal with any of the assets free from the charge so long as it remains floating. When an event occurs which causes the charge to crystallize, it attaches as a fixed security to all the assets then comprised in the relevant class and to any assets of the specified description subsequently acquired by the debtor. Banks and other secured lenders in England will frequently be granted an all assets debenture containing both a fixed and a floating charge. The former covers fixed assets and debts (such as land, intellectual property rights, equipment, shares, and important major contracts), while the latter covers the remaining types of assets such as stock in trade (inventory). In this way, the secured creditor is granted a security interest over all of the debtor's property from time to time. Additionally, the secured creditor is given the right to enforce the security by appointing a receiver under the fixed and floating charges. The receiver, as agent for the debtor, is authorized to take possession of the debtor's assets (and business), continue the debtor's business, and sell its assets to repay the secured debt.

Various consequences flow from creating or characterizing a charge as a floating charge. For example, a floating charge is postponed to the rights of preferential creditors if the secured creditor takes possession of any of the charged assets, or in the event that the company goes into receivership, liquidation, or administration.[30] In addition, a floating charge—given by an insolvent company within the twelve months prior to the onset of insolvency—is void, except as to new value.[31] Furthermore, all floating charges given by a company are required to be registered.[32]

The last thirty years has seen a debate raging in England in relation to the proper characterization of charges over book debts, particularly charges taken by banks labeled in the security documentation as "fixed charges," but operated in a manner that allows the debtor to pay proceeds into its ordinary bank account and use them in the ordinary course of business. In some respects, the debate in the English courts reflects the

30. A fixed charge, on the other hand, has priority over all unsecured claims, preferential or otherwise. The Enterprise Act 2002 reduced significantly the range of preferential debts by abolishing the government's preferential status. *See* Enterprise Act, 2002, c. 40, § 251. Formerly, sums payable to the Crown were preferential. This preference had been criticized for many years as causing hardship to the general body of creditors while producing benefits insignificant in terms of total government receipts.

31. Insolvency Act, 1986, c. 45, § 245.

32. A fixed charge is registerable only if taken over a class of asset listed in section 396 of the Companies Act 1985, or if it would have been registerable as a bill of sale if granted by an individual.

twists and turns that took place in U.S. jurisprudence relating to the validity of security interests created for the purpose of accounts receivable financing and of chattel mortgages on stock in trade following the Supreme Court decision in *Benedict v. Ratner*.[33]

In that case, Justice Brandeis[34] had to consider an arrangement in which the debtor agreed to assign to the creditor its present and future accounts receivable as security for a loan. A list of all the accounts outstanding at the date of the loan was delivered to the secured creditor with a comparable list delivered each succeeding month. Under its arrangements with the secured creditor, the debtor continued to collect the accounts and use the proceeds as it saw fit. It did not account to the secured creditor, nor were the account debtors notified of the assignment.[35] Subsequently, a petition in bankruptcy was filed against the debtor, and Benedict was appointed receiver of the debtor and took over collection of the remaining accounts. The secured creditor petitioned in the bankruptcy proceedings that the receiver be required to pay him the balance of his loan from the proceeds of the assigned receivables. Resisting that petition, the receiver cross-petitioned that the secured creditor be required to turn over to the estate the receivables which the debtor had remitted to him previously as well as any proceeds he might have collected.[36]

The District Court and the Second Circuit held in favor of the secured creditor. However, a unanimous Supreme Court reversed. Justice Brandeis, stating the facts, noted that "there was no finding of fraud in fact."[37] Having concluded that the parties' rights depended mainly on New York law, he formulated the basic legal proposition which determined the decision:

> Under the law of New York a transfer of property as security which reserves to the transferor the right to dispose of the same, or to apply the proceeds thereof, for his own uses, is, as to creditors, fraudulent in law and void.[38]

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33. Benedict v. Ratner, 268 U.S. 353 (1925).

34. For those interested in finding out more about the attitudes, approach, and impact of Justice Brandeis, see EDWARD A. PURCELL, BRANDEIS AND THE PROGRESSIVE CONSTITUTION: ERIE, THE JUDICIAL POWER, AND THE POLITICS OF THE FEDERAL COURTS IN TWENTIETH-CENTURY AMERICA (2000).

35. *Ratner*, 268 U.S. at 358.

36. *Id.*

37. *Id*.

38. *Id*. at 360–61. For an excellent account of the impact of the rule in *Benedict v. Ratner*, see 1 GRANT GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY 250–86

As Professor Gilmore has pointed out, after *Benedict v. Ratner*, a lender was required to exercise "dominion" over his security.[39] What came to be accepted as the proper way of asserting dominion in non-notification financing was a requirement that the proceeds of collection be remitted daily by the assignor to the assignee. Nothing was to go directly into the assignor's bank account; all checks, notes, and acceptances had to be endorsed and delivered to the assignee. Of course, following the remittance there would be what was sometimes referred as a "re-remittance;" after having passed through the assignee's hands, the proceeds would end up in the assignor's bank account. Since receivables were typically assigned to secure a working capital loan, it was necessary that the proceeds eventually be made available for the assignor's use. But under the rule in *Benedict v. Ratner*, it was fatal for the assignor to take the proceeds immediately; they had to be channeled into his bank account through the assignee.

These developments sound very familiar to the English lawyer who has seen the twists, turns, and agonizing in English case law concerning the characterization of purportedly fixed charges over debts taken by banks, starting with the *Siebe Gorman v. Barclays Bank* decision in 1979.[40] The subsequent debate has not related to whether the debtor has or has not created a security interest at all, but whether the security interest was a fixed or floating charge. Justice Brandeis' opinion denies the availability of any kind of security interest where the debtor has the power to deal with the collateral without the consent of the secured lender. As a consequence, U.S. law never developed a judicial concept of the equitable floating charge, and from 1925 until the advent of Article 9 of the Uniform Commercial Code in 1962[41] effectively did without floating liens.[42]

(1965). The *Benedict v. Ratner* decision confirmed a previous line of authority in New York. *See, e.g.*, Zartman v. First Nat'l Bank of Waterloo, 189 N.Y. 267 (1907).

39. GILMORE, *supra* note 38, at 260; *see also* MCCORMACK, supra note 1, at 108–10 (discussing the "sophisticated avoidance industry" that developed after *Benedict v. Ratner* to permit large scale receivables and other financing and the separate legislative initiatives in various states).

40. Siebe Gorman & Co. v. Barclays Bank [1979] 2 Lloyd's Rep. 142 (Ch.).

41. The Uniform Commercial Code creates the functional equivalent of a floating charge. Article 9-205 states that:

> (a) A security interest is not invalid or fraudulent against creditors solely because:
>
> (1) the debtor has the right or ability to:
>
> (A) Use, commingle, or dispose of all or part of the collateral . . . ;
>
> (B) Collect, compromise, enforce or otherwise deal with the collateral;

In the English context, banks have been concerned to show that restrictions in their debentures have established their charges as fixed, while liquidators have been equally astute to seek to strike their charges down as unregistered floating charges or establish that they were only floating charges. This resulted in a substantial volume of litigation after the *Siebe Gorman* decision held that it was possible to take a fixed charge over book debts. The House of Lords in *In re Spectrum* has since overruled *Siebe Gorman*, holding that a secured creditor[43] only had a floating charge over debts where the secured lender's security agreement placed no restriction on the use that the debtor could make of the collected debts paid into the company's ordinary operating account with the secured lender. Accordingly, although the security agreement purported to grant the secured lender a fixed charge in law, it granted only a floating charge, which did not have priority over the claims of preferential creditors.

A debate still rages as to the correct approach to take following the decision in the House of Lords, as well as the nature and extent of restrictions which must be imposed by secured lenders on the debtor's use of proceeds of debts in order to successfully create a fixed charge.[44] This is not the place in which to debate at further length what the correct approach is, though an approach consistent with the rule in *Benedict v. Ratner* would certainly satisfy the *In re Spectrum* test. Furthermore, it is

> . . .
>
> (D) Use, commingle, or dispose of the proceeds; or
>
> (2) the secured creditor fails to require the debtor to account for proceeds or replace collateral.

U.C.C. § 9-205 (2000).

42. Joshua Getzler notes that the decision to exclude floating charges arguably may have enhanced rather than degraded disciplined lending, and strengthened the management and monitoring of debtor companies in the United States by requiring notice to assignees of changes in the collateral and giving chargees a strong legal incentive to police the debtor's business less priority be postponed. Joshua Getzler, *The Role of Security Over Future and Circulating Capital: Evidence from the British Economy Circa 1850–1920*, *in* JOSHUA GETZLER & JENNIFER PAYNE, COMPANY CHARGES: SPECTRUM AND BEYOND 227, 250 (2006).

43. In *In re Spectrum*, the secured creditor was a commercial bank with whom the debtor maintained its ordinary bank accounts, and into which debtor proceeds were paid and withdrawn without restriction. *See In re* Spectrum Plus Ltd. [2005] 2 A.C. 680, 680 (H.L.).

44. *See generally* Gabriel Moss, *Fictions and Floating Charges: Some Reflections on the House of Lords' decision in Spectrum*, *in* JOSHUA GETZLER & JENNIFER PAYNE, COMPANY CHARGES: SPECTRUM AND BEYOND 1 (2006). Gabriel Moss was lead counsel for the bank in the *Spectrum* case, and was originally instructed by me!

probably the case that nothing short of a requirement that the debtor pay proceeds of book debts into a blocked account—from which withdrawals can only be made with the consent from time to time of the secured lender—will be sufficient.[45]

E. Failure to Develop Floating Charges in U.S. Law

In this context, it is interesting to note and impossible to avoid quoting at length the trenchant comments of Dr. Gough concerning the historical development of U.S. law relating to security interests over present and future receivables. In *Company Charges*,[46] Dr. Gough explains:

> United States law never developed the equitable floating charge. In the early seventeenth century, the English common law, as it existed in the time of Lord Coke, was exported to North America. The law as expressed in Bacon's Maxim considered then and now that it is impossible to sell or mortgage future property, which is not presently owned, because there was nothing to convey. English equity in the nineteenth century made the conceptual advance that a mortgage over future property could be effective, without new legal action where the property was subsequently acquired. A contract to assign property, supported by money consideration, meant that title in equity passed automatically on the subsequent acquisition. The effectiveness of a charge over future property made it possible for the English equity courts then to invent the floating charge by making the further mental quantum leap by saying that the future property subject to the charge could change from time to time. This was vital to achiever an effective security over circulating business assets.
>
> Meanwhile, the courts of the American states still remained hidebound by seventeenth century common law prohibitions, unable to overcome conceptual constraints in regard to security over future property. In the 1920's, in the New York case of *Benedict v. Ratner*, a security of present and future accounts receivable was as a matter of judicial policy struck down for the reason that the trading power of the company debtor to continue carrying on business by dealing with assets subject to the mortgage was considered incompatible with the notion of a proprietary right arising by way of mortgage in favor of the creditor. Because the mortgagee could exercise no control over the mortgaged assets by taking possession or requiring the debtor specifically to account for them it was held that there could be no security in existence. For good measure, the court linked the reservation by the mortgagor of a

45. It may well be possible to have debts paid into a blocked account from which withdrawals are rarely made at the same time as the level of borrowings by the debtor debited to another account are allowed to increase.

46. WILLIAM JAMES GOUGH, COMPANY CHARGES (2d ed.1996).

> right to dispose of the mortgaged assets or apply their proceeds for its own use with bankruptcy law principles, by saying that this arrangement created a conclusive presumption of fraud against creditors and therefore that the mortgage assignment was void. In consequence, the Americans had to create a stock-in-trade security in the form of a security interest over 'inventory plus proceeds' through the introduction of legislation. This fundamental legal reform was ultimately introduced in America in 1951 with the promulgation of the first edition of the now famous Article 9 of the Uniform Commercial Code. The Americans only then achieved by legislative code, containing a complex set of priority provisions, a security somewhat equivalent to that invented in England by the courts of equity nearly a century before.
>
> Traditionally, America never developed bank all assets security securing all moneys under multiple credit lines typical in the English and Australian context of branch banking. Article 9 was necessary in America to provide by legislation an all assets business security, effective for stock-in-trade financing purposes, which was prohibited under its common law. American credit and security techniques placed far greater emphasis on dedicated credit lines financing the acquisition of particular classes of assets. American law and practice had a far greater preoccupation with title security and purchase-money security interests. The elaborate statutory priority rules developed in Article 9 and the purchase-money super-priority naturally reflected these different American perceptions and needs. Legal deficiency in relation to all assets security was not true in England and Australasia, which developed a different system of credit and security law and practice, with the branch banking system and the floating charge being very significant differentiating features. England and Australasia developed in the floating charge a convenient form of business security over stock-in-trade, book debts and other circulating assets. The Anglo-Australasian jurisdictions did not need to enact an Article 9 to enable the taking of all assets security.[47]

III. THE CORE ISSUES—SIX POINTS OF COMPARISON

A. Secured Creditor's Rights of Enforcement

1. Secured Creditors' Rights of Enforcement Under English Law

In English law, the position has been radically altered following the implementation of the Enterprise Act 2002 in September 2003. Subject to the exceptions mentioned below, secured creditors with security interests covering the whole or substantially the whole of the debtor's prop-

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[47] *Id.* at 437–38.

erty are no longer able to appoint an administrative receiver, and thereby take control, albeit indirectly, of the realization of the collateral upon enforcement or following the debtor's commencement of an administration proceeding.

Previously, a secured creditor with a security interest including a floating charge in the whole or substantially the whole of the debtor's property could block the commencement by the debtor (or another creditor) of an administration proceeding by appointing an administrative receiver. The court had no jurisdiction to make an administration order in the event that the secured creditor had already appointed an administrative receiver. Administrative receivership was essentially a debt enforcement mechanism for the benefit of the secured creditor who appoints the receiver. The primary function of the administrative receiver was to take control of the debtor's property and effect such disposals as would result in payment of the amount due under the security instrument after allowing for the administrative receiver's remuneration and any sums payable out of floating charge realizations to preferential creditors.[48] Accordingly, the debtor was unable to prevent (by commencing an insolvency proceeding) such a secured creditor from enforcing its security and having management of, and undertaking the process of, selling or otherwise realizing, its assets and business (in so far as they were subject to the security interest). The Enterprise Act 2002, however, largely abolished the institution of administrative receivership, except in the case of charges made before September 15, 2003 and charges exempted from the abolition.[49]

The holder of a fixed and floating charge over the whole or substantially the whole of the debtor's property is now prevented from appointing an administrative receiver. This is true in spite of any provision in the charge which purports to authorize such an appointment. Instead, the legislation now contemplates that the floating chargeholder will normally enforce the security by commencing an administration proceeding. The administration regime has been changed to reflect this development. The quid pro quo for the abolition of the right to appoint an administrative receiver is that the chargee enjoys a number of privileges in an administration not available to others.

48. The receiver owes a primary duty of care to the secured creditor who appointed him, as well as a limited, secondary duty of care to the debtor.

49. The exemptions cover certain important categories of transaction, including capital market arrangements involving a debt of at least £50 million, public-private partnerships, utility projects, urban regeneration projects, and project finance transactions that meet certain criteria. *See* Enterprise Act, 2002, c. 40.

First, the holder of a qualifying floating charge is given the right to appoint an administrator, chosen by him, merely by serving a notice at court with the requisite statutory declaration. Indeed, the chargeholder is able to secure an interim moratorium for up to five business days by filing a notice of intention to appoint an administrator. However, a default or other event is necessary to entitle the chargeholder to enforce the security interest. The secured creditor is also able, like any other creditor, to make an application to the court for an administration order. Where the holder of a qualifying floating charge makes a requisite statement in its application to court, there is an exception to the general rule that the court can only make an administration order where it is satisfied that the debtor is or is likely to become insolvent. Second, whilst the debtor or its directors cannot appoint an administrator out of court, where a petition for winding-up has been presented or an administration application has been made to the court and the petition or application has not been disposed of, no such restriction applies to an appointment by the holder of a qualifying floating charge. Third, where the debtor is in compulsory winding-up (but not in voluntary winding-up) the chargeholder may make an administration application. If the application is granted, the court is required to discharge the winding up order. Finally, the holder of qualifying floating charge who makes an out of court appointment is given the facility of filing the notice of appointment with the court outside court business hours—a point of some considerable practical significance.

2. Secured Creditors' Rights of Enforcement Under U.S. Law

In modern U.S. law and practice, when a major corporation finds itself in financial difficulty, it will file for Chapter 11 protection and will be able to stay all enforcement action by secured creditors. There is no enforcement mechanism, such as administrative receivership, which offers a secured creditor the right to initiate and control the process of managing and realizing collateral independent of the bankruptcy proceeding.

If the collateral is personal property or fixtures, Article 9 of the Uniform Commercial Code (U.C.C.) gives the secured creditor enforcement rights, including the right to take possession of the collateral after default.[50] The secured creditor is given the right, after default, to take possession of the collateral either with or without a judicial process.[51] In addition, the secured creditor has the right to "sell, lease, license, or other-

50. U.C.C. § 9-609 (2000).

51. The secured creditor can only proceed without judicial process if it can do so without a breach of the peace. *Id.* § 9-609(b)(2).

wise dispose of any or all of the collateral in its present condition or following any commercially reasonable preparation or proceeding."[52] If the collateral is realty, the secured creditor can proceed within the framework of the appropriate state mortgage or deed of trust foreclosure statues.

Prior to the commencement of bankruptcy proceedings, a secured creditor is given various enforcement options depending on the nature of the collateral. The U.C.C. governs the exercise of enforcement remedies following default in relation to personal property and fixtures. These include the right to repossess the collateral where tangible personality is involved. In relation to collateral in the form of obligations owed to the debtor by third parties (accounts receivable, executory contract rights, general intangibles, chattel paper, or negotiable instruments) the secured creditor has a right of direct collection.[53] In addition, the secured creditor has the right to effect a foreclosure sale.[54]

Despite the fact that corporate reorganizations in the United States began in the nineteenth century with railroad failures and court appointment of receivers in enforcement actions by secured creditors,[55] U.S. law never developed the concept of the private, out of court, receivership. This can be attributed in part to the failure to develop the floating charge concept, and in part to the codification of secured creditors' enforcement rights under the U.C.C. (which did not include the right).

52. *Id.* § 9-610(a). This includes the right of the secured creditor to purchase the collateral itself either at a public disposition or pursuant to a private disposition ("only if the collateral is of a kind that is customarily sold on a recognized market or the subject of widely distributed standard price quotations"). *Id.* § 9-610(c).

53. *Id.* § 9-607. Where the original assignment of accounts receivable is on a notification basis, the secured creditor has the right to make direct collections even before default. However, if the assignment of the accounts receivable or other third party obligation is on a non-notification basis—as with a simple security interest in accounts—the secured creditor is not entitled to notify the account debtors to make payment until the debtor defaults.

54. *Id.* § 9-610. In the United States, a sale by a secured creditor following the debtor's default is often referred to as a foreclosure sale. This is different from strict foreclosure under English law, where the secured creditor retains and takes title to the collateral in satisfaction of the secured obligations.

55. For an excellent treatment of the history of U.S. bankruptcy law, see DAVID SKEEL, DEBT'S DOMINION: A HISTORY OF BANKRUPTCY LAW IN AMERICA 17–18, 48–70 (2001).

B. The Automatic Stay

1. The Automatic Stay Under English Law

Upon the commencement of an administration[56] without the consent of the administrator or permission of the court, "no step may be taken to enforce security over the company's property."[57] The prohibition on the enforcement of security by a creditor contains a number of component parts.

First, no *step* may be taken to enforce security. The phrase "taking steps" was considered in detail by the Court of Appeal in *Bristol Airport Plc. v. Powdrill*.[58] There, the phrase was given a wide meaning and was held to include a refusal—by those in possession of a chattel who claimed a right of retention over it—to comply with a request from an administrator to deliver up the chattel. This was so even though the refusal involved no positive action by the creditor. Accordingly, in the case of an ordinary possessory lien under English law, the assertion by the lien holder of a right to retain does constitute the taking of a step to enforce security (i.e., the lien), and therefore, in the absence of the administrator's agreement, requires the permission of the court. However, no steps are treated as being taken to enforce the security in this context before a demand for delivery of the chattel is made by the administrator. In addition, even after a demand for delivery has been made, the lien holder has a reasonable time in which to verify the administrator's right to possession.

It remains arguable that the exercise of the contractual right—as part of the process of enforcement of security—may amount to a "step." For example, if a necessary condition precedent to the enforcement of security is the exercise of a right to terminate rights and obligations under a contract (e.g., a bank's obligation to make further advances) by service of a particular notice or the acceleration of the debtor's obligations by the making of a demand for repayment, and the purpose of the exercise of the right and service of the notice is to enable the security to be enforced (that is, is with a view to such enforcement and as a necessary link in the chain of events leading to enforcement), then there is an argument that serving the notice is a step.[59] However, in most cases a problem will not

56. An automatic interim moratorium also applies to the debtor after an application for an administration order has been made, but the administration order has not been granted or dismissed. Insolvency Act, 1986, c. 45, Schedule B1, para. 44(1).

57. *Id.*, c. 45, Schedule B1, para. 43.

58. Bristol Airport Plc. v. Powdrill, [1990] Ch. 744.

59. This was a point which the judge refused to decide in relation to a hire purchase agreement in *Re* David Meek Plant Ltd., [1994] 1 B.C.L.C. 680, 684 (Ch.). The point was

arise since the exercise of such a contractual right will not interfere with the administrator's rights or ability to deal with a particular asset. Where this is not so, it is possible that permission will be required.

Secondly, there must be an *enforcement* of security; what is being done must constitute an enforcement of the security interest. Thirdly, a step must be taken to enforce a "security." This is defined in section 248 of the Insolvency Act of 1986 to mean "any mortgage, charge, lien or other security."[60] It seems from the categories of "security" identified in the definition that only true security interests are covered, or those interests giving proprietary rights in assets belonging to the debtor (or in which the debtor has an interest). Thus, rights which have the same function as security, but do not create proprietary rights in an asset of the debtor (such as set-off) are not included.

The secured creditor may take steps to enforce his security interest where the administrator grants his consent or the court grants leave. The Insolvency Act 1986 does not establish explicitly the basis on which the court is to exercise its discretion to grant leave to lift the stay. However, the case law suggests that English law has developed an approach similar to the U.S. "adequate protection" doctrine.

The Court of Appeal in *In re Atlantic Computer Systems Plc.* recognized that the automatic stay is "intended to assist the [debtor], under the management of the administrator, to achieve the purpose for which the administration order was made."[61] Therefore, the court held that leave should be given where the creditor seeks to exercise his proprietary rights, and the creditor's action is unlikely to impede the achievement of that purpose.[62] However, in other cases, the court went on to say that it:

> has to carry out a balancing exercise, balancing the legitimate interests of the [creditor] and the legitimate interests of the other creditors . . . . In carrying out the balancing exercise, great importance or weight is normally given to the proprietary interests of the [creditor] . . . . The underlying principle here is that an administration for the benefit of unsecured creditors should not be conducted at the expense of those who

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also discussed, but not answered, in *Re* Olympia & York Canary Wharf Ltd., [1993] B.C.L.C. 453, 454 (Ch.), and Barclays Mercantile Business Finance Ltd. v. Sibec Developments Ltd., [1992] 1 W.L.R. 1253, 1259 (Ch.). Professor Goode suggests that "steps to enforce" denotes acts which in some degree interfere with the company's enjoyment of its property or inhibit the administrator's use of such property. Preparatory steps which do not have this effect are outside the mischief of the provision and are not prohibited. *See* GOODE, *supra* note 3, at 352–54.

60. Insolvency Act, 1986, c. 45, § 248.

61. *In re* Atlantic Computer Systems Plc., [1992] Ch. 505, 542 (C.A.).

62. *Id.*

> have proprietary rights which they are seeking to exercise, save to the extent that this may be unavoidable and even then this will usually be acceptable only to a strictly limited extent.[63]

The *In re Atlantic Computer Systems* case dealt with the position of a chattel lessor and not a secured creditor. An application for leave to lift the stay by a secured creditor was considered in *Re Meesan Investments Ltd*.[64] Here, a pre-administration secured creditor sought leave to enforce its security interest in respect of the debtor's real property. The court held that the secured creditor must show particular prejudice and loss so as to differentiate itself from other pre-administration creditors, although it was not necessary to show that the administrator's conduct was in some way improper or unreasonable.[65] The case concerned a bank which held security over a property which the administrator was seeking to let. The bank was unable to persuade the court that it should be given leave to enforce its security despite the fact that the administrator had been seeking to find a tenant for many months and there was evidence that the secured debt, with accruing interest, was nearing the estimated sale value of the property. However, there were some unusual circumstances. The administrator had eventually decided to abandon the attempt to find a tenant and had decided to find a purchaser for the property instead. He had received an offer for the property before the court hearing in an amount which would ensure that the bank was fully repaid. The administrator was also able to show that it was likely that contract for a sale would be exchanged within a month. The court, therefore, was able to conclude that the bank would be fully repaid within a reasonable period of time. The court was sufficiently concerned about the position of the bank to insist that the administrator "return to court in two months' time if he had not achieved a binding contract of sale and, in that event, to give notice to the bank so that it could make such application or submission it thought appropriate."[66]

2. The Automatic Stay Under U.S. Law

When a voluntary or involuntary bankruptcy petition is filed, the automatic stay provided by section 362(a) of the Bankruptcy Code comes into force. The drafters of the Bankruptcy Code considered that:

> the automatic stay is one of the fundamental debtor protections provided by the bankruptcy laws. It gives the debtor a breathing spell from

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63. *Id.*
64. *Re* Meesan Investments Ltd., [1988] 4 B.C.C. 788 (Ch.).
65. *Id.* at 791.
66. *Id.* at 790.

> his creditors. It stops all collection efforts, all harassment, and all foreclosure actions. It permits the debtor to attempt a repayment or reorganization plan, or simply to be relieved of the financial pressures that drove him into bankruptcy.[67]

Section 362(a) identifies a number of acts to which the automatic stay applies. They include:

> (1) the commencement or continuation, including the issuance or employment of process, of a judicial, administrative, or other action or proceeding against the debtor that was or could have been commenced before the commencement of the [bankruptcy case], or to recover a claim against the debtor that arose before the commencement of the [bankruptcy case] . . . ;
>
> (2) the enforcement, against the debtor or against property of the estate, of a judgment obtained before the commencement of the [bankruptcy case];
>
> (3) any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate;
>
> (4) any act to create, perfect, or enforce any lien against property of the estate;
>
> . . .
>
> (6) any act to collect, assess, or recover a claim against the debtor that arose before the commencement of the [bankruptcy case];
>
> . . .
>
> (8) the setoff of any debt owing to the debtor that arose before the commencement of the [bankruptcy case] against any claim against the debtor.[68]

The ambit of the stay is broader than its English counterpart in a number of important respects. Section 362, like the English Insolvency Act of 1986, prohibits any act by a secured creditor to enforce its security interest or to obtain possession of property of the estate. For these purposes, "property of the estate" includes executory contracts and leases, so that the debtor's interest in such contracts and leases is protected against termination or other interference that would have the effect of removing or hindering the debtor's rights in violation of section 362 of the Bankruptcy Code.[69] The prohibition also extends to any attempt to "exercise

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67. H.R. REP. NO. 95-595, at 340 (1977).

68. 11 U.S.C. § 362(a) (2007).

69. *See id*. §§ 362, 363(l), 365(e), 541(a). Note also that most bankruptcy termination clauses may not be enforced after the commencement of a chapter 11 case. These clauses

control over property of the estate."[70] This has been given a broad meaning to include, for example, attempts by a landlord to terminate a master lease which under state law would have resulted in termination of the interest of the debtor as a sub-lessee.[71] Section 362 also prevents the sole shareholder of a Chapter 11 debtor from filing a tax return claiming a worthless stock deduction which, if done, would have eliminated the debtor's net operating loss.[72] In addition, it prevents lenders to a holding company that have been granted a pledge on the stock of a subsidiary from—following default—voting the stock in the subsidiary after the subsidiary has filed a Chapter 11 case.[73]

Section 362(a)(4) covers both judicial and non-judicial actions against property of the estate. A wide variety of actions are stayed automatically, including judicial and private foreclosure and self-help remedies against collateral, such as repossession or notification of account debtors. Each act in the foreclosure process is stayed. Similarly, even if property has been repossessed pursuant to a security interest, the sale of that property is stayed.

The stay covers any "act to collect, assess or recover a [pre-petition] claim against the debtor."[74] The term "act" is broadly construed, and this sub-section is intended to prevent creditor harassment of the debtor in attempting to collect pre-petition debts. The conduct prohibited ranges from that of an informal nature, such as a telephone contact, to more formal judicial and administrative proceedings. However, simple ministerial acts, such as the presentment of a note, are not included. Serving a notice of acceleration of indebtedness may be subject to the effect of the automatic stay, even where the purpose of serving a notice of acceleration is to preserve rights and fix an interest rate rather than to collect indebtedness at the time of the notice.[75]

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are generally unenforceable under sections 363, 365, and 541 of the Bankruptcy Code and any attempted enforcement is stayed.

70. *Id*. § 362(a)(3).

71. *See In re* 48th Street Steakhouse, Inc., 835 F.2d 427, 431 (2d Cir. 1987).

72. *See* Official Comm. of Unsecured Creditors v. PSS Steamship Co., 928 F.2d 565, 574 (2d Cir. 1991).

73. *See* Official Bondholders Comm. v. Chase Manhattan Bank, 209 B.R. 832, 838 (D. Del. 1997). In this case, the lenders obtained relief from the automatic stay in the holding company's Chapter 11 case, permitting them to vote the shares which served as their collateral.

74. 11 U.S.C. § 362(a)(6).

75. *See In re* Texaco Inc., 73 B.R. 960, 967 (Bankr. S.D.N.Y. 1987). Where the notice of acceleration will not give the creditor an advantage over other unsecured creditors, filing of such notice may be permitted by the court. Note also that "although section 362

In addition to the self effectuating injunction of section 362, under section 105 of the Bankruptcy Code, the court has the discretionary power to stay action by creditors not subject to the automatic stay. Unlike the section 362 stay, a section 105 stay is not automatic. Therefore, a creditor whose action is not within the scope of the section 362 stay may continue to act, pending the court's determination. The standard for relief under section 105 is vague, and as a consequence, provides the court with considerable latitude in determining when the automatic stay should be extended. Specifically, section 105(a) requires the court to find that the relief requested is "necessary or appropriate" to carry out the provisions of the Code.[76] Thus, under section 105, depending on the circumstances, a debtor may be able to extend the stay to creditor actions against third parties such as guarantors or co-debtors.

Of the various exceptions to the automatic stay, one is of particular interest to secured lenders. Section 362(b)(3) of the Bankruptcy Code excepts "any act to perfect, or to maintain or continue the perfection of, an interest [such as a security interest] in property" if "applicable law . . . permits perfection of an interest in property to be effective against a person entity [including the debtor in possession] that acquires rights in such property before the date of perfection," or if the act occurs within thirty days after the transfer becomes effective between transferor and transferee.[77] Accordingly, if a creditor is granted a purchase money security interest in an item of collateral and the borrower files a bankruptcy petition the following day (and before the creditor has filed a U.C.C. financing statement with respect to the collateral), the creditor will be free to file the necessary financing statement without a violation of the automatic stay because Revised U.C.C. section 9-317(e) permits a secured party to file with respect to a purchase money security interest within twenty days after the debtor receives delivery of the collateral and still has priority over any intervening lien creditor. Note also that section 362(d)(2) of the Bankruptcy Code allows a secured creditor to obtain relief from the automatic stay where "the debtor does not have an equity in [the collateral]; and [the collateral] is not necessary to an effective reorganization."[78]

The Bankruptcy Code permits parties to request that the court determine whether the interest of a secured lender in property (including a

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stays foreclosure, it need not be read to preclude acceleration." *In re* LHD Realty Corp., 726 F.2d 327, 332 (7th Cir. 1984).

76. 11 U.S.C. § 105(a).

77. *Id*. §§ 362(b)(3), 546(b)(1), 547(e)(2)(A).

78. *Id*. § 362(d)(2).

security interest) is adequately protected[79] when the trustee or debtor in possession is using, selling, leasing, or borrowing against the property, or when the secured lender is otherwise stayed from enforcing its interest. These sections do not authorize the court to impose adequate protection. Instead, the parties may agree on appropriate protection, the secured creditor may request particular protection, or the trustee or debtor in possession may propose protection that it believes is adequate. Any such agreement is subject to court approval, and in the absence of agreement, the court must determine whether in fact the protection is adequate. "Adequate protection" is mandated by certain provisions of the Bankruptcy Code when requested by an entity with an interest in property in which the estate also has an interest. An entity is entitled to adequate protection as a matter of right, not merely as a matter of discretion, when the entity is stayed from enforcing its interest when the estate proposes to use, sell, or lease property in which the entity has an interest, or when property on which the entity has a lien is to be used as collateral for a loan. Adequate protection is required to protect a secured creditor's interest in property. Yet protection for the entire bundle of rights of the secured creditor is not required. In effect, protection is required only for the value of a secured creditor's interest in the property. If a secured creditor's claim exceeds the value of its interest in property, only the interest is entitled to protection. The remainder of the claim is unsecured and does not give rise to an interest in property that requires protection.

The claim of an oversecured creditor will generally increase over time as it accrues interest. Even if the value of the property is constant, any equity cushion will decrease as the amount of the claim increases. Nevertheless, adequate protection is not intended to protect the creditor's right to continue to accrue interest. Put another way, the oversecured creditor's allowed secured claim for post-petition interest is limited to the amount that a creditor was oversecured at the time of the filing. Consequently, the creditor is not entitled to a constant equity cushion. Instead, a decrease of the equity cushion as interest accrues should not adversely affect the viability of the cushion, at least until the cushion becomes insufficient to continue to protect the petition date amount of the secured claim against declines in the value of the property. An oversecured creditor is not entitled to receive periodic cash payments for accruing post-petition interest as part of that creditor's adequate protection in order to preserve the value of its equity cushion or otherwise. It is the decline in the value of the collateral against which protection is provided, not the perpetuation of the ratio of collateral to debt.

79. *Id.* § 361 (defining "adequate protection").

Although a secured party is entitled to protection of the value of its interest, it is not entitled to profit from the trustee's services that might enhance the value of the interest. Section 506(c) permits the trustee to recover from the property costs and expenses of preserving or disposing of the property concerned to the extent of any benefit to the secured creditor. A secured creditor is not entitled to protection against such expenses any more than protection against the accrual of interest, the more so because section 506(c) permits the trustee to recover the expenses from the collateral even when the claim is undersecured. However, when the secured creditor is diligently seeking relief from the automatic stay, or to prevent or condition the use of collateral by the debtor under section 362(d) or 363(e), section 506(c) is narrowly applied to prevent the estate from profiting at the expense of a secured creditor who is seeking to remove its collateral from the control of the debtor, and the issue of costs of preservation or disposal should be determined in the early stages of the litigation, perhaps at a preliminary hearing.

The most important message of the Bankruptcy Code with respect to the treatment of an entity with an interest in property of the estate, or in the possession of the estate, is that its remedies may be suspended, even abrogated. The right of recourse to collateral may be terminated as the collateral is consumed in the business, as long as the value of its secured position is adequately protected. However, courts are divided on the question of whether the value to be protected is the value of the interest as of the date of the request for protection, or as of the commencement of the case.

Adequate protection may take many forms, only some of which are illustrated in section 361. When the collateral consists of inventory and accounts, adequate protection may require the provision of necessary accounting information, as well as additional or replacement collateral to compensate the creditor for its inability to enforce its after acquired property clause and the loss of collateral that would result from the debtor's use of the proceeds of the inventory or accounts. When the collateral consists of rents from real estate, adequate protection, at least for an interim period, may consist of a requirement that some portion, or all of the rents, be applied in a certain manner, perhaps to pay taxes, other senior liens, or interest. Of course, in some instances in which the value of the collateral is not declining, nothing more than insurance, taxes, and appropriate reporting may be needed to protect the value of the secured position.

The first suggested alternative of section 361 requires the debtor to make a cash payment, or periodic cash payments, to the affected secured lender to the extent that the stay of section 362, the use, sale, or lease under section 363, or the grant of lien under section 364 results in a decrease in the value of such entity's interest in the estate's property. The payments are intended to protect the secured lender against a decrease in the value of the property, which would directly affect his interest in the property.[80]

The second alternative suggested in section 361 provides an additional or replacement lien to the extent necessary to compensate for a decrease in value of the secured creditor's interest in the debtor's property. Again, this does not necessarily mean that the creditor's "cushion" is to be protected, although a creditor may be entitled to some cushion as part of the value of its interest in property. Each case must be decided upon its particular facts.[81]

The grant of additional or replacement liens may be particularly appropriate when the affected creditor holds a "floating lien" on after-acquired property, such as inventory or accounts. The lien on collateral acquired after commencement of the case is cut off by section 552(a). If the debtor proposes to use, sell, or lease the collateral in the continuing operation of the debtor's business, the amount and value of the creditor's collateral may decrease if it is not replaced by newly acquired inventory or accounts. Although technically the creditor's interest can continue in the proceeds, notwithstanding section 552(a), the proceeds are likely to be cash that will need to be spent in the continuing operation of the business. This cash will be cash collateral, the use of which requires adequate protection. One likely form of protection is to continue the lien of the creditor on accounts or inventory acquired after commencement of the case, as long as it is clear from the facts that this will provide adequate protection, while at the same time not creating a windfall to the secured creditor. Often, new inventory will be acquired with the proceeds of inventory or accounts. However, it may be difficult to trace the proceeds into the new inventory. Permitting attachment of a security interest to the after-acquired property may remove this problem.

The last alternative for adequate protection is a catch-all, permitting such other relief "as will result in the realization by such entity of the indubitable equivalent of such entity's interest in such property."[82]

80. *Id*. § 361(1).
81. *Id*. § 361(2).
82. *Id*.

C. The After-Acquired Property Clause

1. The After-Acquired Property Clause in English Insolvency Proceedings

Under English law, an agreement for security over after-acquired property is treated as creating a present (not a contingent) security interest that cannot take effect until the property has been acquired. Once value has been given for the grant of the security interest, each asset coming in under the after-acquired property clause is deemed to have been given for new value. The agreement for security over after-acquired property constitutes a present security; it creates an inchoate security interest which waits for the asset to be acquired so that it can fasten onto the asset. However, upon acquisition of the asset, the security interest takes effect as from the date of the security agreement.[83]

The commencement of a winding up proceeding does not prevent the after-acquired property clause from having effect. A new asset arising after the commencement of the debtor's winding-up becomes instantly caught by the secured creditor's security interest (provided that the consideration for the security interest was already executed before the commencement of the winding up—that is, the secured lender had already advanced funds to the debtor).[84]

The after-acquired property clause is effective to catch property coming into the company's hands after the commencement of the winding up despite section 127 of the Insolvency Act 1986, which renders void any disposition of the company's property made after the commencement of the winding up. Since the security interest relates back to the time of the security agreement there is no conflict with section 127.[85]

There are some exceptions to, and criticisms of, this rule. Sums recovered by a liquidator as a result of a successful preference claim have been held to be designated to benefit only unsecured creditors, thereby falling outside assets charged by a security agreement.[86]

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83. *See* ROY GOODE, LEGAL PROBLEMS OF CREDIT AND SECURITY 69–71 (3d ed. 2003).

84. *In re* Lind [1915] 2 Ch. 345 (C.A.); *In re* Reis [1904] 2 K.B. 769 (C.A.).

85. Note also that the exercise of a power of sale by a mortgagee or receiver after commencement of the winding up does not contravene the prohibition in section 127 against post-commencement dispositions, since to the extent that the asset being sold is subject to the security interest it is not property of the debtor at all. *See* Sowman v. David Samuel Trust Ltd., [1978] 1 W.L.R. 22 (Ch.).

86. *In re* M.C. Bacon Ltd., [1991] Ch. 127, 137; *See In re* Yagerphone, Ltd., [1935] Ch. 392, 396.

> It was . . . established long before 1986 that any sum recovered from a creditor who has been wrongly preferred enures for the benefit of the general body of creditors, not for the benefit of the company or the holder of a floating charge. It does not become part of the company's assets but is received by the liquidator impressed with a trust in favor of those creditors amongst whom he has to distribute the assets of the company.[87]

This approach is the result of a construction of the statutory right of action to recover a preference and the purpose for which such a right of action was created. It was not intended to be exercised so as to enable a secured creditor to obtain the benefit of the proceedings brought by a liquidator. However, recoveries by a liquidator for "misfeasance" (breach of duty) against directors and others will usually fall within the property charged. This is because the section which creates the right for a liquidator to bring a misfeasance action, unlike the sections dealing with preferences (and the sections dealing with transactions at an undervalue and claims against directors resulting from wrongful trading), does not create a separate right or remedy available to a liquidator, but merely a special procedure for recovery by the company of its claims arising from a breach of duty.[88] Thus, whereas the cause of action, which is the subject of a misfeasance summons, may exist prior to the winding up of the company, and thus are subject to the floating charge and after-acquired property clause, rights of action for wrongful trading, preferences, and transactions at an undervalue exist solely by virtue of the winding up of the company and cannot exist before such winding up.

Administrators are also given the power to bring proceedings to recover property invoking the statutory avoidable preference and transaction at an undervalue provisions. The same approach as that applied in a winding-up to recoveries for preference and transactions at an undervalue should apply in administrations.[89]

There has been some debate as to whether the rule is justified or whether it runs counter to the policy of insolvency law.[90] Professor Goode has concluded that insofar as English law allows the chargee to increase his security margin during the preference period (generally six months prior to the commencement of the liquidation), the criticism is

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87. *See In re* M.C. Bacon Ltd. [1991] Ch. at 137.

88. Insolvency Act, 1986, c. 45, § 212.

89. *See* GAVIN LIGHTMAN & GABRIEL MOSS, THE LAW OF RECEIVERS AND ADMINISTRATORS OF COMPANIES 241–43 (3d ed. 2000).

90. *See* GOODE, *supra* note 83, at 69–71; *see also* Paul Matthews, *The Effect of Bankruptcy upon Mortgages of Future Property*, 1 LLOYD'S MAR. & COMM. L.Q. 40 (1981) (U.K.).

well taken.[91] However, enhancement of the security margin of the secured creditor outside this period seems to be unobjectionable. The secured creditor is entitled to assert security rights over future property without putting in fresh value because he is not taking out of the estate more than he put into it; within the debtor's acceptance of the after-acquired property clause, the money would never have been advanced in the first place.

Professor Goode's position, of course, reflects the position that exists under the U.S. Bankruptcy Code. Section 547(c)(5) deals with the preference period, where the debtor receives after-acquired inventory (stock in trade or accounts receivable debt) subject to the security agreement. This provision requires the bankruptcy court to examine the collateral/debt amounts at two points: (1) at the start of the preference period, and (2) at the moment of the filing of the Chapter 11 petition. The provision condemns a security interest as preferential to the extent that the lender has improved its position between those two dates.

The impact of an administration proceeding on the rights of a secured creditor to property acquired by the debtor during the administration proceeding is in large part regulated by the relevant provisions in the Insolvency Act of 1986. The administrator "may dispose of or take action relating to property which is subject to a floating charge as if it were not subject to the charge."[92] Where property is disposed of in reliance on this power, "the holder of the floating charge shall have the same priority in respect of acquired property as he had in respect of the property disposed of."[93] "Acquired property" means "property of the company which directly or indirectly represents the property disposed of."[94] In other words, the priority previously enjoyed in relation to the disposed of property carries through to its products or proceeds. These statutory provisions effectively validate in administrations the operation of the after-acquired property clause.

It should also be noted, however, that the administrator may, with the permission of the court, dispose of property subject to a security other than a floating charge as if it was not subject to the security. The court's power to grant permission is exercisable only on the application of the administrator and only where it is satisfied that the "disposal of the property would be likely to promote the purpose of the administration in respect of the company."[95] It is a required condition of any order giving

91. *See* GOODE, *supra* note 83, at 71.
92. Insolvency Act, 1986, c. 45, Schedule B1, para. 70(1).
93. *Id.*, c. 45, Schedule B1, para. 70(2).
94. *Id.*, c. 45, Schedule B1, para. 70(3).
95. *Id.*, c. 45, Schedule B1, para. 71.

leave to dispose of the property that the net proceeds of sale plus the amount by which those proceeds fall short of the value of the property determined by the court as the net amount which would be realized by sale on the open market by a willing vendor are to be applied in discharging the sums secured by the displaced security.

2. The After-Acquired Property Clause in U.S. Bankruptcy Proceedings

Under the Uniform Commercial Code, a security agreement may validly create a security interest in collateral acquired after its execution.[96] However, section 552 of the Bankruptcy Code limits the effect of such after-acquired property clauses in a subsequent bankruptcy case. Generally, a pre-petition security interest does not attach to property acquired after the commencement of the bankruptcy case.[97]

However, if the security agreement provides that the security interest extends to "proceeds, product, offspring, or profit" of the collateral, the security interest of the lender in such collateral is valid in the bankruptcy case unless the court, after notice and a hearing, limits this post-petition effect of the security interest "based on the equities of the case."[98] The legislative history relating to this provision indicates that the exception to the post-petition effect of the security interest is intended to cover a situation where assets of the estate, not subject to the security interest, are utilized in the completion and sale of collateral at an expense to the debtor's estate and thereby depleted the funds available for the general unsecured creditors to the benefit of the secured creditor.

Thus, it has been held that a lender's security interest in pre-petition crops extends to post-petition crops produced with the proceeds of pre-petition crops,[99] and a secured creditor's perfected security interest in rents and profits on real property extend to post-petition rents and profits.[100] However, a bank's pre-petition security interest was held not to attach to crops planted after the petition was filed.[101] In addition, a creditor's lien in hotel revenues, which were characterized as "accounts" under Article 9 of the U.C.C. rather than "rents" under section 552 of the

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96. U.C.C. § 9-204 (2000).

97. *See, e.g.*, Alliance Capital Mgmt. L.P. v. County of Orange (*In re* County of Orange) 179 B.R. 185 (Bankr. C.D. Cal. 1995) (pre-petition security interest of lenders, on certain tax and other future revenues of a Chapter 9 county debtor, to secure repayment of general revenue bonds terminates under section 552(a); noteholders thus had no lien against debtor's post-petition revenues).

98. 11 U.S.C. § 552(b)(1).

99. *E.g.*, *In re* Thacker, 291 B.R. 831 (Bankr. S.D. Ill. 2003).

100. *E.g.*, *In re* SLC Ltd. V, 152 B.R. 755 (Bankr. D. Utah 1993).

101. *E.g.*, Matter of Hunerdosse, 85 B.R. 999 (Bankr. S.D. Iowa 1988).

Bankruptcy Code,[102] did not extend to post-petition revenues.[103] Moreover, a creditor's lien on "rents, income and profits" from a debtor's farmland did not extend to new crops which the debtor plants post-petition by utilizing post-petition income and funds from another party.[104]

In order to avoid to the greatest extent possible the limitations contained in section 552, security agreements will usually provide for a security interest in proceeds, rents, issues, and profits. If all of the materials consumed in the manufacturing process (and perhaps the funds used to pay the labor component) are subject to the lender's security interest, the bankruptcy court should have no basis to invoke its equitable power to limit the security interest. In addition, the security documentation may contain provisions to facilitate the creditor's tracing of proceeds of collateral.

D. The Debtor's Power to Use Collateral and Sell the Collateral Free and Clear of the Security Interest

1. Debtor's Right to Use Secured Assets in Administration Proceedings

An administrator is deemed to act as agent of the debtor in exercising his powers.[105] These powers, which are wide-ranging, are to be exercised to enable the administrator to achieve the statutory purpose of the administration procedure. Since the Enterprise Act of 2002, there is one statutory purpose within which there is a threefold hierarchy. Paragraph 3(1) of Schedule B1 to the Insolvency Act of 1986 states:

> *Purpose of administration*

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102. Section 552(2) of the Bankruptcy Code states that where the pre-petition security interest extends to:

> property of the debtor acquired before the commencement of the case and to amounts paid as rents of such property or the fees, charges, accounts, or other payments for the use or occupancy of rooms and other public facilities in hotels, motels, or other lodging properties, then such security interest extends to such rents and such fees, charges, accounts, or other payments acquired by the estate after the commencement of the case to the extent provided in such security agreement except to any extent that the court, after notice and a hearing and based on the equities of the case, orders otherwise.

11 U.S.C. § 552(2) (2000).

103. *In re* Northview Corp., 130 B.R. 543 (9th Cir. Bankr. App. 1991).

104. *E.g.*, *In re* Olsen, 87 B.R. 148 (Bankr. D. Colo. 1988).

105. Insolvency Act, 1986, c. 45, Schedule B1, para. 69.

3(1) The administrator of a company must perform his functions with the objective of—

(a) rescuing the company as a going concern, or

(b) achieving a better result for the company's creditors as a whole than would be likely if the company were wound up (without first being in administration), or

(c) realising property in order to make a distribution to one or more secured or preferential creditors.

(2) Subject to sub-paragraph (4), the administrator of a company must perform his functions in the interests of the company's creditors as a whole.

(3) The administrator must perform his functions with the objective specified in sub-paragraph (1)(a) unless he thinks either—

(a) that is it not reasonably practicable to achieve that objective, or

(b) that the objective specified in sub-paragraph (1)(b) would achieve a better result for the company's creditors as a whole.

(4) The administrator may perform his functions with the objective specified in sub-paragraph (1)(c) only if—

(a) he thinks that it is not reasonably practicable to achieve either of the objectives specified in sub-paragraph (1)(a) and (b), and

(b) he does not unnecessarily harm the interest of the creditors of the company as a whole.[106]

To enable the administrator to achieve the statutory purpose, he has broad management powers in relation to the debtor's property, including the power to "do anything necessary or expedient for the management of the affairs, business and property of the [debtor]."[107] Furthermore, as noted, the administrator is given certain powers to deal with charged property. In many cases, in order to achieve the statutory purpose of administration, the administer will need to be able to use or dispose of all the debtor's property, including that part of it which is charged to a secured lender.

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106. *Id.*, c. 45, Schedule B1, para. 3.

107. *Id.*, c. 45, Schedule B1, para. 59(1). The administrator's powers are set out in a long list in Schedule 1 to the Insolvency Act.

In the case of assets subject to any security which when created was a floating charge, the administrator is given the power to dispose of such assets, or otherwise take action relating to such property, as if the assets were not subject to the floating charge. Accordingly, the administrator can deal with such assets and dispose of them as he sees fits without reference to the floating chargeholder, and, presumably, without being fettered by any contractual restrictions contained within the floating charge, such as a negative pledge clause.[108] This power to use assets enables the administrator to trade the debtor's business notwithstanding the existence of the floating charge security. As noted above, where the security interest over debts and receivables is a floating charge, the administrator will have the ability to fund the administration by using proceeds resulting from repayments of debts and receivables without needing to obtain the consent of the secured lender. The secured lender is protected because he is granted the same priority as he had in relation to the floating charge assets in respect of any of property directly or indirectly representing the disposed of assets. Accordingly, if the administrator, for example, sells plant machinery subject to the floating charge, the proceeds of the sale will fall within the floating charge and the holder of the charge will be entitled to the same priority as against third parties (e.g., holders of subsequent floating charges) in respect of the proceeds as he had over the disposed of plant machinery.[109]

If the administrator wishes to dispose of collateral subject to a fixed charge, he must apply to the court for an order authorizing him to do so. The court may make such an order only where the court thinks that disposal of the property would be likely to promote the purpose of administration. The court must make it a condition of any such order that the net proceeds of disposal together with any further sums required to be added to the net proceeds so as to produce the amount determined by the court as the net amount which would be realized on the sale of the property at market value be applied towards discharging the sums secured by the fixed charge. Accordingly, the administrator is able to dispose of fixed charge assets where, for example, he wishes to sell the whole of the debtor's business and assets (where such a sale promotes the statutory purpose), even if the fixed charge holder does not give his consent.

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108. If the floating charge assets are to be regarded in the administrator's hands as not being subject to the charge, then it follows that the contractual provisions in the floating charge relating to dealings with such assets will not operate so as to bind the administrator. Otherwise the contractual stipulations would be promoted to a status superior to the proprietary rights granted by the security.

109. Note that the administrator is obliged to set aside a prescribed part of the debtor's net property for unsecured creditors out of floating charge assets coming into his hands.

2. Debtor's Right to Use Secured Assets in Chapter 11 Proceedings

The existence of a lender's security interest in property of the debtor—either because it is pre-petition property subject to a pre-petition security interest or because it is post-petition proceeds of pre-petition collateral in which a security interest has attached pursuant to section 552(b) of the Bankruptcy Code—does not prevent the debtor from using, selling, or leasing the collateral (and perhaps drastically reducing its value) if the debtor complies with the provisions governing such use, sale, or lease set forth in section 363 of the Bankruptcy Code.

While section 363 contains important protections for secured lenders, a lender can almost never rely on the statutory provisions to provide complete protection. The vigorous involvement of the secured lender in asserting its rights under section 363 is considered absolutely essential to prevent a diminution in its collateral position. A passive lender may find (perhaps too late) that the debtor has persuaded the court to "rubber stamp" its proposed uses of the lender's collateral, which imperils its value. Furthermore, not all the protective provisions are automatic. Thus, a lender's security interest in collateral will receive protection from the court only if the lender so requests.

Under section 363(a), "cash collateral" includes cash and cash equivalents (such as deposit accounts, negotiable instruments and documents of title) in which a secured party has an interest. Cash collateral also includes proceeds of pre-petition collateral, such as post-petition collections of pre-petition accounts, to the extent the security interest in such proceeds is recognized as valid under the Bankruptcy Code.

Unless the secured party with an interest in cash collateral consents to its use by the debtor, cash collateral may not be used unless the court authorizes such use after notice to interested parties and the opportunity for a hearing. At any such hearing, or at any time thereafter, the secured party having an interest in cash collateral may request the court to "prohibit or condition such use," to the extent necessary to provide adequate protection of the secured party's interest in such cash collateral. The secured party will have the burden of proving its interest in cash collateral. However, the debtor must show that the creditor's interest is adequately protected before the court will authorize the debtor's use of a lender's cash collateral.[110]

110. An example is helpful in understanding the application of section 363 of the Bankruptcy Code. Assume that a lender provided working capital financing to the debtor prior to the filing of the Chapter 11 petition by making advances based on "eligible" accounts and inventory. Assume further that the lender either does not desire to continue financing the debtor on a post-petition basis, or, if such financing is contemplated, it is

Typically, court authorization to use cash collateral will be sought immediately upon filing of the Chapter 11 petition or very shortly thereafter. Because a pre-petition secured lender has the right to adequate protection in order to safeguard its interests, the lender has significant bargaining leverage in arriving at a consensual arrangement for the debtor to use cash collateral.

The most common form of adequate protection provided to a pre-petition lender for the use of its cash collateral is a replacement lien on other assets of the debtor. For example, a creditor may be offered as adequate protection a lien on accounts that the debtor intends to create with the use of the cash collateral or a lien on some of the debtor's fixed assets.

Because the use of cash collateral by a debtor does not involve the advance of new funds to the debtor, but rather involves the use by the debtor of funds that are subject to the lender's security interest, the grant of a replacement lien is not intended to provide a lender with additional security over and above what it holds at the time the use of cash collateral is authorized. Rather, the purpose of a replacement lien on assets of the debtor is to provide protection to the lender in the event that the lender's collateral position is adversely affected by the debtor's use of its cash collateral. Thus, for example, a lender may be granted a replacement lien on post-petition inventory acquired by the debtor, and the lender will be able to look to that inventory as security in the event of a dissipation of its cash collateral.

The trustee or debtor in possession has the right to use, sell, or lease non-cash collateral (such as inventory, machinery, and equipment) in the ordinary course of its business without obtaining court approval. As a result, a lender will be required to initiate a request for specific adequate protection for such use, and it is recommended that such protection be requested as early as possible during the case as permitted by section 363(e) and Federal Rule of Bankruptcy Procedure 4001(b).

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uncertain whether cross-collateralization provisions can be obtained in a financing order. Subsequent to the filing of the Chapter 11 petition, the debtor receives collections on the pre-petition accounts that would ordinarily be remitted to the pre-petition lender to pay down the loan. Upon the filing of the Chapter 11 petition, such collections constitute cash collateral and the debtor may use such cash collateral subject to the limitations of section 363 of the Bankruptcy Code. Under these circumstances, the pre-petition lender will be concerned as to whether the debtor will be permitted to use the lender's cash collateral and for what purposes. If adequate safeguards on the use of a pre-petition lender's cash collateral are not imposed, the lender could see an important element of its collateral dissipated in the daily operations of an unprofitable debtor. *See* ROBERT J. ROSENBERG ET AL., COLLIER LENDING INSTITUTIONS AND THE BANKRUPTCY CODE § 4.05 (1986).

As with the use of cash collateral, adequate protection should include replacement liens and additional liens on property of the debtor. However, because non-cash collateral is subject to depreciation during the course of the case (whereas cash collateral has a fixed value), the lender may be successful in a request to obtain periodic cash payments equal to the amount of the depreciation if he can demonstrate that his collateral is so depreciating. Such payments are expressly authorized as a form of adequate protection.

Under section 363(b)(1), the use, sale, or lease of the debtor's property outside the ordinary course of business requires court approval after notice and a hearing to interested parties. For example, if the debtor proposed to sell one of its several manufacturing plants, it would require court approval under section 363(b)(1). For court approval, the sale must be in the best interests of the estate, requiring findings of a fair and reasonable price and good faith. Sales of certain personally identifiable information are subject to further limitation.

If the debtor would like to sell property in which another party has a security interest, it must also comply with section 363(f). Generally, the requirements of section 363(f) are met either by obtaining the consent of the party holding the lien, or by having the lien or security interest attach to the proceeds of the sale. Obviously, such sales can be either very favorable or adverse to the lender. If, for example, the property is sold at an amount in excess of the debt to the lender, the lender will, in effect, have had the bankruptcy court conduct a foreclosure sale for its benefit (without the attendant potential liability arising from a lender's non-bankruptcy conduct of a foreclosure sale), and obtain repayment. However, in other situations, the debtor may propose to sell the property at a price which the lender believes is less than the actual value of the property. A lender, under such circumstances, could object to the proposed sale as not being in the best interest of the estate. In the alternative, a lender could, unless the court orders otherwise, "bid in" its secured claim (i.e., apply the amount of its claim as an offset against the purchase price), purchase the property and resell the property at a higher value.

E. Post-Petition Financing, Expenses, and Surcharges

1. The Administration Expenses Doctrine and Secured Creditors Under English Law

The provisions governing the payment by the administrator of expenses incurred by him during the administration and for payment of his remuneration are contained in paragraph 99 of Schedule B1 of the Insolvency Act 1986 (and rule 2.67 of the Insolvency Rules 1986), which focuses on the position when the administrator vacates office. These provisions impose a statutory charge over the debtor's property in the custody or control of the administrator at the time of his vacation of office, and are of no effect before then. Although, strictly, sums payable under the statutory charge only become payable when the administrator vacates office, it is well understood that administrators will, in the ordinary way, pay expenses of the administration as they arise during the continuation of the administration. What is picked up at the end of the administration by the statutory charge are those sums payable under the statutory charge which have not at that point been paid.

In recovering his expenses and remuneration, the administrator is only entitled to resort to assets that are the property of the company. His rights are subordinate to those of a holder of a fixed charge, but take priority over claims secured by a floating charge.

The ranking of the administrator's entitlement to expenses and remuneration from floating charge assets is as follows:

> (1) sums payable in respect of debt or liability arising under a contract made by the administrator, or a contract of employment adopted by the administration, before cessation of his appointment;
>
> (2) the administrator's remuneration and expenses (which between themselves are to rank in the order set out in the Insolvency Rules);[111]
>
> (3) the prescribed part which the administrator is required to set aside for ordinary unsecured creditors from assets subject to a floating charge if created on or after 15 September 2003 and remaining after preferential debts have been paid.[112]

The term "expenses" was not defined in the Insolvency Act 1986. However, the Insolvency Rules were amended in 2003 by adding Rule 2.67, which lists nine categories of expenses, including "necessary disbursements by the administrator,"[113] and provides that they are payable in the order listed in Rule 2.67(1). The reference to expenses in paragraph 99 is to mean and comprise the items listed in Rule 2.67(1).

Prior to the enactment of the Enterprise Act 2002, there was considerable uncertainty as to which liabilities could be treated as expenses. For example, there was an issue as to whether the statutory language allowed claims arising under pre-administration contracts to be paid as expenses

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111. Rule 2.67(1) of the Insolvency Rules, 1986, S.I. 1986/1925, contains a list of nine items, the first of which is "expenses properly incurred by the administrator in performing his functions in the administration of the company."

112. Insolvency Act, 1986, c. 45, Schedule B1, para. 99.

113. Insolvency Rules, 1986, Rule 2.67(1)(f).

in circumstances where the benefit of a contract had been used by the administrator to assist the administration (e.g., rent payable under pre-administration real estate leases where the leased property had been occupied during the to the estate's benefit). Under the old law, the statutory reference was to "expenses incurred by the administrator," which limited expenses to claims for which the administrator was personally liable. The law thereby excluded liabilities arising under pre-administration contracts, and only liabilities under contracts "entered into" by the administrator were covered by the other provisions relating to the administrator's statutory charge. However, the courts had held that, separately from and in addition to the statutory charge provisions in the Insolvency Act of 1986, the court has the power, at its discretion, to direct an administrator to discharge liabilities out of assets in his hands even if they are not technically "expenses."[114] The court's jurisdiction was held to arise because the administrator is an officer of the court, and by virtue of the administration moratorium on the enforcement by creditors of their rights.

It has been held recently that the changes made by the Enterprise Act 2002 have significantly amended the law. In *Re Trident Fashions*,[115] the court held that business rates on property occupied by the company during the administration were to be treated as an expense (a "necessary disbursement") because Rule 2.67 had changed the law so that the position in administrations is now the same as that in liquidations. Liabilities incurred by the company after the commencement of the administration must be paid as necessary disbursements; the liability to pay business rates arose by reference to the company's period of occupation.
The liquidation language had been held[116] to exclude any exercise of discretion by the court in determining whether the liquidator should pay expenses falling within the liquidation rule.[117] Where a liability falls within the applicable rule, it has to be paid, and the court has no discretion to exercise. This decision does not address the treatment of liabilities under pre-administration contracts.

It remains to be seen whether this approach will be followed when the issue is tested at the appellate level. At the time of writing, the decision is

114. *In re* Atlantic Computer Systems Plc. [1992] Ch. 505, 520–30 (C.A.).

115. *Re* Trident Fashions, [2007] E.W.H.C. 400 (Ch.); *see also* Freakley v. Centre Reinsurance Int'l, [2006] U.K.H.L. 45. The decision of the House of Lords in *Freakley* related to the law prior to the changes made by the Enterprise Act 2002. Administration expenses used (in section 19(4) of the Insolvency Act) to have to be "expenses properly incurred by the administrator," but now the reference in the Act is to the "[administrator's] expenses." Insolvency Act, 1986, c. 45, Schedule B1, para. 99(3).

116. *See In re* Toshoku Finance U.K. Plc. [2002] 1 W.L.R. 671 (H.L.)

117. *See* Insolvency Rules, 1986, Rule 4.218.

controversial, not least because a principled basis for analyzing the nature of expenses in an administration remains to be established.

It should be noted that where the administrator needs to borrow funds for the purpose of the administration, these provisions allow him to do so, and to create new, post-administration security interests, with priority over pre-administration floating charge assets. However, there is no ability to prime and subordinate assets subject to a pre-administration fixed charge.

2. Post-Petition Financing in Chapter 11 Cases and the Impact on Pre-Petition Secured Creditors

The Bankruptcy Code contains various provisions designed to assist a debtor in obtaining post-petition financing in connection with the debtor's Chapter 11 proceedings. The Code authorizes various different types of financing that may be permitted starting with unsecured borrowing and concluding with the creation of new first priority liens ranking ahead of existing pre-petition security interests.

Section 364(a) permits a debtor to obtain unsecured credit or incur post-petition unsecured indebtedness in the "ordinary course of business." No court approval is required for such transactions provided that the ordinary course of business standard is satisfied. Post-petition indebtedness, incurred by a debtor in the ordinary course of business, and interest payable on such indebtedness, is entitled to an administrative expense priority that is *pari passu* with all other administrative expenses, and is senior to all other priorities (e.g., wage claims and tax claims) in the Bankruptcy Code priority ranking scheme, with the exception of "super-priorities" (which are senior to administrative expense priorities).

Under section 364(b), the bankruptcy court, after proper "notice and a hearing," may approve an unsecured post-petition loan or extension of credit that is not in the ordinary course of business. Any such loan or extension of credit will have the same administrative expense priority as any extension of credit under section 364(a).

Most potential post-petition lenders are understandably reluctant to advance funds to the debtor and receive solely an administrative expense claim. Despite the impressive-sounding first priority status accorded the administrative expense claim granted to a post-petition lender pursuant to a court-authorized section 364(b) lending arrangement, in a liquidation, the lender's administrative expense claim will be *pari passu*, rather than senior to, all other administrative expenses. Other administrative expense claims would include claims of all parties who have provided goods or services to the debtor during the Chapter 11 period (including, but not limited to, supplier's claims, fees of attorneys, accountants and special consultants, and the fees of any professionals retained by the official creditors' committee and equity security holders' committee). In addition, if a Chapter 11 case is subsequently converted to a liquidation case under Chapter 7, Chapter 7 administrative expense claims will be senior to the Chapter 11 administrative expense claims. Upon liquidation, after payments to all secured creditors, all entities holding claims entitled to superpriority, and all holders of Chapter 7 administrative claims, little may be left for post-petition lenders who hold claims with Chapter 11 administrative expense status.

For these reasons, a post-petition lender will usually require additional protection before agreeing to provide a debtor with post-petition financing. Section 364(c)(1) permits a post-petition lender to obtain such additional protection by obtaining "superpriority" over all administrative expenses.[118] To obtain a superpriority claim, court approval is required, and a showing must be made that the debtor is unable to obtain unsecured credit allowable as an ordinary administrative expense. To support the request for a superpriority, a lender will need to testify in court that it will not advance funds to the debtor unless it receives a superpriority claim.

Section 364(c) also provides a method for a post-petition lender to receive, either in addition to, or exclusive of, a superpriority claim, security interests in assets of the debtor. However, as with any post-petition financing under section 364(c), in which the lender is granted a superpriority, if the lender is granted liens and security interests in assets of the debtor, the financing arrangement must be approved by the bankruptcy court after notice and a hearing. In addition, the fininancing arrangement requires a showing that unsecured credit allowable as an administrative expense cannot otherwise be obtained by the debtor. If the foregoing requirements are met, the post-petition financing may be secured (pursuant to section 364(c)) by a lien on unencumbered property of the debtor, or by a junior lien on property of the debtor, that is already subject to a lien.

Section 364(d) is a less common method of providing secured post-petition financing to a debtor than section 364(c), because section 364(d) financings generally adversely affect the security position of a pre-petition secured lender. Section 364(d) permits the debtor to obtain credit secured by a senior or equal lien on property of the debtor that is already subject to a lien. As a result, in the absence of consent by the existing

118. Note that some courts insist on a "carve out" from superpriority status and post-petition liens in a reasonable amount designed to provide for the payment of the fees of the debtor's and creditors' committee's counsel and possible trustee's counsel in order to preserve the adversary system. *E.g.*, *In re* Ocean Power Corp., 2007 WL 949598 (Bankr. S.D.N.Y. 2007).

lienholder, attempted financings under section 364 are likely to be vigorously opposed by the lender whose lien is to be "primed." To obtain financing under section 364(d), the debtor must demonstrate to the court that it cannot otherwise obtain financing, and that the "primed" lender either consents or will be provided "adequate protection" of its interest in its collateral. Thus, section 364(d) permits the bankruptcy court to "prime" the lien of one lender in favor of another lender if the court determines that the interest of the lender being primed is afforded "adequate protection." Courts have held that a primed lender has been afforded adequate protection if: (1) the debtor demonstrates that sufficient equity will remain in the collateral after the senior or additional lien is granted to cover the indebtedness of the primed lender; or (2) the proceeds from the loan to be secured by the senior or additional lien will result in an increase in the value of the collateral.[119] However, courts and commentators have criticized the granting of priming liens on collateral where the existing creditor is undersecured. In cases permitting an undersecured creditor's lien to be primed, some courts have found that adequate protection is afforded based on the likelihood that the collateral value will be enhanced.[120] A debtor seeking approval of a priming lien, but not offering additional collateral to the existing secured creditor, would need to put forward strong evidence (including credible financial projections) to establish that the proposed priming financing will enhance collateral value.

A court must value the collateral in order to determine whether sufficient equity is in a lender's collateral to justify granting an additional or senior lien on such collateral, or whether the proceeds from the loan to be secured by the senior or additional lien would result in an increase in the value of the collateral. To value the collateral properly, the court must determine which valuation standard should be used. Some courts have used a going concern (rather than a liquidation) analysis to value existing facilities after determining that the debtor is not likely to be liquidated.[121] Courts have also found that a primed lender can be afforded adequate protection if the lender is granted replacement liens on the debtor's other assets.[122]

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119. *See, e.g.*, *In re* Chicago, Missouri and Western Ry. Co., 90 B.R. 344 (Bankr. N.D. Ill. 1988).

120. *E.g.*, *In re* Sky Valley, 100 B.R. 107 (Bankr. N.D. Ga. 1988).

121. *E.g.*, *In re* Beker Industries Corp., 58 B.R. 725 (Bankr. S.D.N.Y. 1986).

122. *E.g.*, *In re* TNT Farms, 226 B.R. 436 (Bankr. D. Idaho 1998).

3. The Expenses Doctrine in Chapter 11 and Its Impact on Secured Creditors

The Bankruptcy Code establishes different levels of priority for expenses—priority and superpriority. Section 507 is entitled "priorities," but it does not encompass the full range of the Code's priority rules. Other sections confer "super" priorities on a claimant.

In a Chapter 7 liquidation, expenses generally rank after the claims of secured creditors. In a Chapter 11 case, the timing and ordering of payments depends on the terms of the plan of reorganization. The plan must comply with certain core rules. First, the plan can only be confirmed if priority claims are paid in full in cash on the effective date of the plan. In addition, a secured creditor's collateral can, in certain circumstances, be surcharged with the costs and expenses of preserving the collateral thereby ensuring that the secured creditor does not recover the full value of his security.

Section 503 of the Bankruptcy Code provides for the "allowance" of administrative expenses. Section 503(a) authorizes a party to file a request for payment of an administrative expense. Section 503(b) provides that administrative expenses of the type described therein are to be allowed by the court after notice and a hearing. While there are various exceptions, administrative expenses are generally those that are incurred by the estate after the commencement of the Chapter 11 case.

Section 503 derives its importance from section 507. Section 507 provides that certain categories of expenses and claims[123] have priority in the distribution of the assets of the estate. Section 507 lists ten categories of priority claims. The second priority, set forth in subsection 507(a)(2), consists of administrative expenses allowed under section 503(b). The impact of section 507, and hence of section 503, is somewhat different in cases filed under different chapters of the Code.

In a Chapter 7 case, property of the estate is distributed according to the distribution schedule of section 726. This section provides that property is first distributed by payment of claims of a kind and in the order specified in section 507. But all of these claims rank after secured claims. Therefore, secured creditors are entitled to be paid full up to the value of the collateral securing their claim before unsecured claims are paid at all.

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123. One of the most important concepts in the Bankruptcy Code is that of a "claim." Claims are paid, if allowed, and claims are discharged. "Claim" is defined very broadly, and is intended to cover all legal obligations of the debtor no matter how remote or contingent. *See* 11 U.S.C. § 101(5)(A) (2007). Even a right to an equitable remedy can constitute a claim, including rights giving rise to the remedy of an injunction or specific performance if the debtor's breach gives rise to a right to payment.

In a Chapter 11 case, payments are made according to the terms of a confirmed plan of reorganization (as opposed to a distribution by the trustee). A plan can only be confirmed if it provides for the full payment of section 507(a) priority claims in cash, unless the holder of the claim has agreed to a different treatment. As a result, some of these claims may fail to be paid before secured claims.

Section 503(b) states that the administrative expenses "include" the nine listed categories. Section 102(3) further provides that the terms "include" and "including" are not to be construed as limitations. The result is that the nine described categories cannot be considered an exhaustive list of all of the types of claims that are entitled to administrative priority treatment. The court may determine that additional types of claims are expenses that should be accorded administrative priority in a particular case. A court is not free to determine that a claim qualifying as an administrative expense under the express language of section 503(b) should not share in administrative priority with other administrative expenses, or should be subordinate to payment of other administrative expenses.

In general, all claims allowable under section 503(b) as administrative expenses share equally as first-priority claims. However, section 507(b) of the Code grants a "superpriority" to certain administrative expense claims of secured creditors, which come into being due to a shortfall arising between the adequate protection ordered by the court under sections 362, 363, or 364, and the actual loss in value of the property in which the secured creditor has a lien. A claim enjoying this "superpriority" has priority over all other unsecured claims, including those entitled to administrative priority under section 507(a)(1).

The order of priority of administrative claims can also be affected by an even greater "superpriority" arising under section 364(c) of the Code when necessary to enable the trustee to obtain unsecured credit. This claim is given priority even over the superpriority claim of section 507(b). Section 364(c) provides that the court may authorize the estate to obtain credit with a priority over all other administrative expenses if the trustee is unable to obtain unsecured credit allowable under section 503(b)(1) of this title as a mere administrative expense.

The first of the specified types of claims allowable as administrative expenses are those described by section 503(b)(1)(A) as "the actual, necessary costs and expenses of preserving the estate."[124] Section 503(b)(1)(A) makes no attempt to enumerate potential items of expense that fit within the phrase other than to state that it does include "wages, salaries, or commissions for services rendered after the commencement

124. 11 U.S.C. § 503(b)(1)(A) (2000).

of the case" and certain back pay awards pursuant to a judicial or National Labor Relations Board proceeding. Based on the wording of section 503(b)(1)(A), courts have developed several tests for determining whether a particular claim qualifies for being an actual and necessary cost of preserving the estate. Many courts have stated generally that for a debt to qualify as a necessary preservation expense, the debt must satisfy two requirements: (1) it must have arisen from a transaction with the estate; and (2) it must have benefited the estate in some demonstrable way.[125]

The general bankruptcy rule, as noted above, is that, absent an express agreement to the contrary, the expenses associated with administering a bankruptcy estate are not chargeable to a secured creditor's collateral or claim. Instead, the expenses but must be borne out of the unencumbered assets of the estate. But an important exception to this general rule is set out in section 506(c), which permits a debtor to recover administrative expenses from a secured creditor's collateral if three conditions are satisfied: (i) the expenses are "necessary" to preserve or dispose of the collateral; (ii) the expenses are "reasonable"; and (iii) the incurrence of the expenses provides a "benefit" to the secured creditor. Similarly, expenses may be recoverable where the secured creditor expressly or impliedly consents to the incurrence of the expense, or caused the expense. In addition, as amended in 2005, section 506(c) expressly includes as part of the amounts that may be charged against the secured party's collateral all *ad valorem* property taxes with respect to the collateral.

In general, a secured creditor receives a "benefit" within the meaning of section 506(c) if the relevant expense preserved or increased the value of its collateral. The general concern underlying this requirement is the prevention of a windfall to the secured creditor. A secured creditor should not reap the benefit of actions taken to preserve the secured creditor's collateral without shouldering the cost. In addition, expenses are "necessary" to the extent that they relate to the preservation or disposition of the secured creditor's collateral, and then only to the extent they are not attributable to any unwarranted delay by a party other than the secured creditor. Finally, expenses are "reasonable" to the extent that they are incurred in the ordinary course at a reasonable price.

125. *E.g.*, *In re* Smith, 315 B.R. 77 (Bankr. W.D. Ark. 2004).

F. The Ability to Vary and Cram Down Security Interests Within the Bankruptcy Proceedings

1. The Ability of Administration Proceedings to Vary and Cram Down Security Interests

Unlike Chapter 11, the administration procedure does not incorporate a mechanism for varying or discharging creditors' rights. The administrator is required to prepare proposals to be placed before creditors and on which creditors are allowed to vote. However, these are merely proposals for achieving the purpose of administration—how he proposes to manage the business, affairs, and property of the debtor so as to rescue the company as a going concern, or, if that is not reasonably practicable or produces a result for the company's creditors that as a whole is worse than an alternative course of action, pursue a course of action that will produce a better result for creditors than a winding up.

In most cases, the administrator's statement of proposals has to be accompanied by an invitation to creditors to attend the initial creditors' meeting at which the proposals are considered. The date set for this meeting must be "as soon as is reasonably practicable after the debtor enters administration," and "in any event, within a period of ten weeks beginning with the date on which the company enters administration."[126] At the meeting of creditors, creditors may approve the administrator's proposals with or without modification. But, where there are modifications, the administrator must give his consent. The "majority (in value) vote of those present and voting, in person or by proxy," is required to pass a resolution to approve the administrator's proposals.[127] Any resolution, however, is invalid if those voting against it include more than half of the creditors to whom notice of the meeting was sent, and who are not, to the best of the belief of the chairman at the meeting, persons connected with the company.

At such a creditors' meeting, however, a secured creditor is entitled to vote only in respect of the balance (if any) of his debts, after deducting the value of his security as estimated by him. Accordingly, a partly secured creditor will only be entitled to vote on the administrator's proposals to the extent of his shortfall. The unsecured creditors are the constituency who control approval of administration proposals.

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126. Insolvency Act, 1986, c. 45, Schedule B1, para. 51(2). Note that these time limits may be varied by the court on an application of the administrator, or by up to twenty-eight days with the consent of creditors. *See id.*, c. 45, Schedule B1, para. 51(4).

127. Insolvency Rules, 1986, Rule 2.43.

The reason for this is that an administrator's statement of proposals may not include "any action which affects the right of a secured creditor of the company to enforce his security."[128] Thus while the secured creditor is disenfranchised and prevented from voting on the administrator's proposals to the extent that the value of his collateral exceeds his secured debt, he is protected because of the limits imposed on what can be included in the administrator's proposals. As a practical matter, therefore, the administrator must agree with the secured creditor on a course of action at least in so far as the administrator needs to propose steps which would affect the right of the secured creditor to "enforce" his security. It remains to be seen as to what action can be proposed which affects the position, but not the enforcement rights, of the secured creditor.

There are, however, certain circumstances in which the administrator does not need to convene an initial creditors' meeting to consider his proposals. The administrator can dispense with the initial creditors' meeting, and does not need to have his proposals approved, where his "statement of proposals states that [he] thinks that (a) the company has sufficient property to enable each creditor to be paid in full, (b) that the company has insufficient property to enable a distribution to be made to unsecured creditors . . . , or (c) that it is not reasonably practicable to rescue the company as a going concern or implement an alternative strategy which produces a better result for creditors than the winding up."[129] This authority to dispense with the need to summon an initial creditors' meeting was introduced by the Enterprise Act 2002 and applies in circumstances where there is likely to be nothing of substance that a creditors' meeting could decide.

Even though the administrator is not required in these circumstances to summon a creditors' meeting on his own initiative, he is required to do so if requested by creditors whose debts amount to at least ten percent of the total debts of the company. Where a creditors' meeting is held, and the administrator has included in his statement of proposals that the debtor has insufficient property to enable it to make a distribution to unsecured creditors, then the secured creditor is entitled vote in respect of the full value of his secured debt without deducting the value of his security.[130]

The English equivalent to the Chapter 11 plan of reorganization is contained in separate statutory provisions in the Insolvency Act 1986 and the Companies Act 1985. A company voluntary arrangement (CVA) is made

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128. Insolvency Act, 1986, c. 45, Schedule B1, para. 73(1).
129. *Id.*, c. 45, Schedule B1, para. 52(1).
130. Insolvency Rules, 1986, Rule 2.40(2).

pursuant to the provisions of Part I of the Insolvency Act 1986 and is a composition in satisfaction of the debtor's debts or a scheme of arrangements of its affairs resulting from acceptance of a proposal made to creditors. Such a proposal can be made by the directors of the debtor whether or not the debtor is insolvent or likely to become insolvent. It can also be proposed by an administrator, and the administrator's proposals, where necessary, can include a statement that the administrator intends to achieve the purpose of administration by proposing a CVA.

Thus, a CVA may run in parallel with an administration, but, without an administration, the CVA process does not generate an automatic stay.[131] For this reason, many CVAs are conducted within the framework of administration. The normal procedure in these circumstances is for the administrator to continue to manage the debtor until the CVA is approved. At that point, the administrator will pass over assets or trading surpluses to the supervisor of the CVA for distribution among creditors. Usually, the supervisor is the administrator himself.

When a CVA proposal is made by an administrator, a creditors' meeting must be summoned, at which creditors vote on the CVA proposal. A creditor entitled to vote is bound by the CVA even if he did not receive notice of the meeting, or, having received notice of the meeting, he chooses not to attend or to vote by proxy. Thus, a creditor not entitled to vote is not bound by a CVA. The general rule is that every creditor who has notice of the creditors' meeting is entitled to vote at the meeting. In order for the CVA to be approved, there must be a majority vote in excess of three-quarters of the creditors present (in person or by proxy). As with the administrator's proposals, a meeting summoned to approve a CVA must not approve any proposal which "affects the right of the secured creditor of the company to enforce his security, except with the concurrence of the creditor concerned."[132]

As an alternative to a company voluntary arrangement, an administrator can propose a scheme of arrangement under section 425 of the Companies Act of 1985. This section declares that where any compromise or arrangement is proposed between a company and its creditors, or any class of them, the court may order a meeting of the creditors to be called. Additionally, if three-fourths of creditors present either in person by proxy agree to the compromise or arrangement (and it is also sanctioned by the court), it will be binding on all the creditors and on the company.

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131. Note there is separate moratorium proceeding available to small companies only, which does give rise that an automatic stay.

132. Insolvency Act, 1986, c. 45, § 4(3).

Schemes of arrangement are binding only on those creditors who are made a party to the scheme. It is not necessary for the debtor to have a scheme of arrangement with all creditors. However, it is necessary for the debtor to identify the separate classes of creditors, and for each separate class to approve the scheme by the requisite majority. There is no equivalent to the Chapter 11 concept of cram-down. Whereas a Chapter 11 plan of reorganization can be confirmed even if a class of creditors votes against it (provided that the conditions to a cram-down contained in the Bankruptcy Code are satisfied), if a separate class of creditors votes against a scheme of arrangement they cannot be bound. The responsibility for determining what creditors are to be summoned to any meeting as constituting a separate class rests upon the debtor. If the meeting is incorrectly convened or constituted, or any objection is taken to the presence of any particular creditors as having interests competing with the others, the objection must be taken at this stage.[133] A scheme of arrangement can relate to the debtor's secured creditors, but secured creditors are likely to be a separate class (or perhaps classes) which can only be bound if the class votes by the requisite majority to support the scheme. Furthermore, in the context of an administration, it seems that a scheme cannot be proposed without the consent of all the secured creditors, where the scheme affects the enforcement rights of secured creditors.

In order for the scheme to become effective, it must be sanctioned by the court at a hearing held after creditors have voted. Importantly, even though there is no statutory authority on this point, the court may ignore the fact that a class has not consented to the scheme if it is proved that upon an immediate distribution of the assets, none would be available for that class.[134] It has been held that creditors' meetings are unnecessary where a scheme involves no risk to them.[135] Additionally, it has been held that where one class of creditors had voted against the scheme, and so was consequently not bound by it, the court could sanction the scheme in so far as it affected the remaining creditors who had voted in favor of

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133. The classic test of what is a class for these purposes was laid down by Lord Justice Bowen in *Sovereign Life Assurance v. Dodd*, [1892] 2 Q.B. 573, 583 (C.A.), stating that "it must be confined to those persons whose rights are not so dissimilar as to make it impossible for them to consult together with a view to their common interest." There have recently been a number of significant cases considering the classes question. *See, e.g., In re* Hawk Ins. Co. Ltd., [2002] B.C.C. 300, 309–10 (Ch.).

134. *See In re* MyTravel Group Plc., [2005] 1 W.L.R. 2365 (C.A.); *In re* Oceanic Steam Navigation Co. [1939] 1 Ch. 41 (C.A.); *In re* Sorsbie [1904] 1 Ch. 12 (C.A.).

135. *See Re* A.G.L. Sydney Ltd., (1994) 13 A.C.S.R. 597 (N.S.W. Sup. Ct.) (Austl.).

it.[136] There is currently considerable controversy in England as to whether it is proper to value the debtor's assets on a break up or liquidation basis, rather than on the basis of a going concern enterprise value when determining whether a class of creditors, including secured creditors, has an interest in the assets of the debtor and would be entitled to a distribution therefrom.[137]

2. The Cram-Down of Secured Creditors Under Chapter 11[138]

Confirmation of a plan of reorganization is the statutory goal of every Chapter 11 case. Section 1129 of the Bankruptcy Code provides the requirements for such confirmation, containing Congress's minimum requirements for allowing an entity to discharge its unpaid debts and continue its operations. These requirements are numerous, and differ depending on whether confirmation is consensual or not. If consensual confirmation is sought, section 1129(a) governs. It contains thirteen paragraphs, each of which contains a separate requirement that must be met in order to confirm the plan. Among the critical requirements are the best interest of creditors test and the feasibility test.

If non-consensual confirmation is sought, then section 1129(b) controls, which incorporates all but one of the paragraphs of section 1129(a). It adopts twelve of the thirteen section 1129(a) requirements, omitting only the requirement that all classes consent or be unimpaired. In addition, section 1129(b) adds two more requirements. First, the plan may not unfairly discriminate against dissenting classes. Second, the plan's treatment of such dissenting classes must be fair and equitable.

Before the court hears evidence on these matters, however, much will have happened. The plan proponent will have drafted and disseminated a disclosure statement approved by the court regarding the effect of the plan. The creditors and interest holders will have been solicited for their votes, and will have voted. Parties in interest will have filed any objections they may have. Only after this large amount of work has been done will the court then allow the proponent to demonstrate that its plan deserves confirmation.

Although section 1129(b)(1) sets out a complete test for non-consensual confirmation, Congress added a subsection to illustrate some of the components of the fair and equitable rule. This section has re-

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136. *Barclays Nat'l Bank Ltd v HJ de Vos Boerdery* 1980 (4) SA 475 (S. Afr.).

137. *See* Michael Crystal & Rizwaan Jameel Mokal, *The Valuation of Distressed Companies: A Conceptual Framework, Parts I & II*, 3 J. INT'L CORP. RESCUE 63, 123 (2006).

138. See WILLIAM MILLER COLLIER, COLLIER ON BANKRUPTCY § 1129.05 (Lawrence P. King ed., 1996), for a general discussion of this topic.

ceived the lion's share of judicial attention, representing a carefully delineated explanation of various types of fair and equitable treatment. The preamble to section 1129(b)(2) states that "[f]or the purpose of this subsection, the condition that a plan be fair and equitable with respect to a class includes the following requirements." What follows is an extensive list of possible non-consensual treatments of secured and unsecured creditors, and of interest holders.

The first subparagraph of section 1129(b)(2) states that it applies with respect to a class of "secured claims." Under the Code, a secured claim is one that is either "secured by a lien on property in which the estate has an interest" or one that is "subject to setoff under section 553."[139] The amount of the claim secured is limited "to the extent of the value of such creditor's interest in the estate's interest in such property," or "to the extent of the amount subject to setoff." There are three possible situations which involve a class of secured claims. First, a creditor may have collateral that is worth more that the amount of its allowed claim. For example, a creditor may have a claim of $50 secured by collateral having a value of $75. In this case, the creditor has one claim, and it is a secured claim of $50. In addition, a creditor might also have taken security pre-bankruptcy which has subsequently become worthless. If the claim was $50, and the value of the collateral is now zero, the creditor has one claim, but it is unsecured and will not be subject to section 1129(b)(2)(A). A final example is representative of most litigated cases, where a creditor may have a claim in excess of the value of its collateral. To reverse the prior example, the claim may be for $75, and be secured by a lien on property worth only $50. In this case, the creditor has two claims: a secured claim for $50, and an unsecured claim for the deficiency for $25. Only the secured claim will be subject to section 1129(b)(2)(A).

Section 1129(b)(2)(A) lists three possible treatments of a secured claim, any one of which will independently satisfy the fair and equitable requirement. First, the plan proponent may seek to satisfy the claim in full by giving the creditor a note in the amount of the secured claim secured by the same collateral. Second, the plan proponent may also seek to sell the collateral free of the lien, and transfer the lien to the proceeds of sale. Third, the proponent may seek to give the creditor the "indubitable equivalent" of its claim.

Section 1129(b)(2)(A)(i) provides the terms under which the plan proponent may unilaterally write a new loan. First, the holder of the claim must "retain the lien securing [its] claims" regardless of who winds up

139. 11 U.S.C. § 506 (2007).

with the property. Secondly, the holder of the claim must "receive on account of such claim deferred cash payments totalling at least the allowed amount of such claim, of a value, as of the effective date of the plan, of at least the value of such holder's interest in the estate's interest in such property." The primary issue litigated under section 1129(b)(2)(A)(i) is the appropriate interest rate that the deferred payments will bear. As indicated in the legislative history, if the interest rate is a "market rate," then the principal of the note needs only to equal the allowed amount of the claim. If the plan proponent chooses a rate which is less that the "market" rate, then the stream of payments will not have a present value equal to the allowed amount of the claim. There is no requirement that the lender's pre-petition security agreement or mortgage be used in order for the lender to retain its lien. As noted by the Court of Appeals for the Fifth Circuit: "We interpret the plan as ensuring [retention of a lien] if the debtor fails to comply with its debt service obligations, [the secured creditor] would have the right to foreclose."[140]

Many loans amortize between the date of issue and maturity; that is, they call for payments which, if timely made, will leave a zero principal balance at maturity. A reorganized debtor's projected cash flow, however, may not support a fully amortizing loan. The legislative history suggests that balloon payments may be appropriate, or that a plan may adopt non-standard repayment schedules adapted to the reorganized debtor's business needs. The secured creditor's protection here is the feasibility requirement of section 1129(a)(11). If the plan calls for minuscule payments for twenty years, and a balloon payment on resale at the end of that period, then plan's feasibility, and possibly good faith, could be called into question.

A second example of fair and equitable treatment is contained in section 1129(b)(2)(A)(ii). It provides that a plan is fair and equitable as to a secured creditor if the plan provides for the sale, subject to section 363(k), of any property that is subject to the liens securing such claims, free and clear of such liens, with such liens to attach to the proceeds of such sale, and the treatment of such liens on proceeds under clause (i) or (iii) of that subparagraph. This clause anticipates six components: (1) a sale; (2) subject to section 363(k); (3) of property subject to the lien; (4) which sale is free and clear of the liens; (5) with the liens to attach to the proceeds; and (6) deferred payments or indubitable equivalent.

The plan must anticipate a sale, either contained in the plan itself, or post-confirmation. Inclusion of the sale in the plan is not troublesome, as

140. Matter of Briscoe Enterprises, Ltd., 994 F.2d 1160, 1169 (5th Cir. 1993).

section 1123 expressly anticipates that a sale of all or some assets can be a means to implement the plan.

The sale must be subject to section 363(k) of the Bankruptcy Code. This section provides that "unless the court for cause orders otherwise the holder of [the secured] claim may bid at such sale, and, if the holder of such claim purchases such property, such holder may offset such claim against the purchase price of such property." This gives the secured creditor protections against attempts to sell the collateral too cheaply. If the secured party thinks the collateral is worth more than the debtor is selling it for, it may effectively bid its debt and take title to the property.

The final option under section 1129(b)(2)(A) is that a plan may be confirmed against a secured creditor's wishes if the plan provides "for the realization by such holders of the indubitable equivalent of such claims." Two examples will illustrate the operation of this provision. First, abandonment (or other unqualified transfer) of the collateral to the secured creditor satisfies this requirement. Second, provision of a payment stream with a present value less than the allowed amount of the claim will not suffice. Third, plans which call for substitute collateral, although contemplated by the legislative history of the Code, have also been disfavored unless the creditor receives a "substitute of the most indubitable equivalence," providing for present value and safety of principal. In cases of this sort, whether the substitute collateral's value exceeds the allowed secured claim is critical. Plans which propose to give an oversecured creditor no payments for a period followed by transfer if the collateral is not sold by a certain time, however, have met with favor so long as the court is satisfied that there will always be more value in the property than the lender's lien.

IV. CONCLUSION

The secured creditor is still treated differently in U.K. and U.S. rescue/reorganisation proceedings. While the law in both jurisdictions has changed and continues to change in ways that bring the two systems closer together—in large part because of the changing role and conception of the rescue/reorganisation proceeding itself—the secured creditor's position is significantly stronger in the United Kingdom.

The administration procedure pays considerable deference to the wishes and interests of the secured creditor, first by allowing the holder of a qualifying floating charge to control key aspects of the case (the law allows such a secured creditor to commence an administration without a court application, to trump the company's choice of administrator if the company files for administration, and requires the administration to be conducted for the benefit of the secured creditor—by realizing the company's property to make a distribution to the secured creditor where neither a rescue nor a restructuring that achieves a better recovery than a liquidation are reasonably practicable) and secondly by immunising him from the adverse effects of the procedure (by ensuring that the administrator's proposals and any CVA proposed by the administrator cannot affect his right to enforce his security).

While the Chapter 11 regime provides substantial protections for pre-petition secured creditors, the nature of the process, even after the 2005 reforms, means that secured creditors have significantly less control than in administration proceedings, are forced to be more active in and to litigate over the protection of their rights and outcomes are less predictable, in large part because of litigation risk.

Furthermore, the difference in deference applies not only in the debtor—secured creditor relationship but also at the level of the inter-creditor relationship—a key pressure point in most large rescue and reorganisation proceedings. In the United Kingdom, the rights, freedom of action, and position of senior creditors have been well respected and protected although the extent of these protections (particularly in light of the complex financing structures with multiple tiers of secured debt and inter-creditor agreements) may well come to be tested in the next, perhaps more litigious and U.S.-style, era of restructurings.