# G. UCC Article 9: Proposed Twenty Percent Set Aside For Unsecured Creditors

ELA

Equipment Leasing Association of America

November 7, 1996

Professor Geoffrey C. Hazard, Jr.
Director, The American Law Institute
4025 Chestnut Street
Philadelphia, PA 19104

RE: UCC ARTICLE 9: PROPOSED TWENTY PERCENT SET ASIDE FOR UNSECURED CREDITORS

Dear Professor Hazard:

I am writing to you on behalf of the Equipment Leasing Association (ELA)[1] to comment on the proposal of a legal academic for radical change to UCC Article 9. Overturning well established law on commercial lending, the Proposal would limit the effectiveness of security interests to 80% of a business debtor's assets. The impact of this Proposal would be in a debtor's bankruptcy— "carving out" 20% of the assets for application of administrative expenses, such as attorneys fees, and for the claims of other creditors. A secured party would be fully secured in the event of the debtor's bankruptcy only to the extent that its loan to collateral value ratio did not exceed 80%.

We strongly oppose this Proposal. Our views are supported by the Commercial Finance Association, the Mortgage Bankers Association, responsible academic writers, and several Committees of the American Bar Association, all of which object to the Proposal as injurious to commercial lenders, small business and other debtors, and the free flow of commercial financing.

1. Vagueness, Overbreadth, and Unfairness. The sweeping 20% set aside Proposal is vague about how it would affect secured creditors' rights under the Bankruptcy Code §§303 (b) (1), 547 and 544(a) and under federal tax lien law. See Professor James J. White's June 3, 1996 letter to Edwin E. Smith,

[1] ELA is the major national trade association in the multi-billion dollar equipment leasing industry. Over 700 member companies of ELA engage in commercial lending and lease financing transactions, involving every imaginable type of equipment, throughout the United States and overseas. The United States Department of Commerce estimates that, out of the $571.1 billion spent by American business on productive assets in 1995, $160.7 billion (or 28%) was acquired through leasing. It forecasts that in 1996 leasing will account for $169.1 billion (or 29%) of the $582.1 billion that will be invested in equipment in the United States.

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earlier circulated by ALI [hereinafter "White"]. Yet under any fair reading, the Proposal would allow a set of unsecured creditors seriatim to take virtually all of the collateral of a prior secured creditor. See id. Another aspect of the Proposal is that it would allow junior subordinate secured creditors to leapfrog senior debt holders, by the simple expedient of obtaining a judicial lien.[2] Nothing in law, equity, or sound policy supports these unfair results.

Advocates for the Proposal say there is a need to curb "oversecuritization." But the Proposal is not limited to attacking oversecuritization practices (i.e., blanket liens that are grossly disproportionate to the amount of the lender's loan). Instead, it applies to every secured loan, even where the security is the specific collateral financed. In this respect, the Proposal would undercut purchase money security financing, which is important to equipment lease financing and which traditionally has been viewed as imposing no direct costs on general creditors.

It is certainly unclear that the Proposal is the best way to address concerns about oversecuritization. Were it adopted as law, the Proposal might actually encourage oversecuritization. Secured lenders might well respond to a diminution in their assured collateral by (among other things) requiring borrowers to pledge more collateral to cover the shortfall.

2. The Bankruptcy Code and the UCC. The central theme of the Proposal is that unsecured creditors should be given special rights vis-a-vis secured creditors. But unsecured creditors typically charge higher rates, and they often are able to protect themselves in other ways that do not involve artificially limiting the collateral of secured creditors. For example, unsecured trade creditors, who generally extend credit in increments over time, may limit their

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[2] As Professor White points out: "If Citicorp, a junior secured creditor, had lent $20 million to Chase's debtor [which earlier borrowed $100 million from senior secured creditor Chase], Citicorp would be foolish to pursue its security interest. Instead it could sue the debtor and, as a judicial lienor, trump Chase even though it began life as a subordinate secured creditor. Principal beneficiaries of the Proposal are likely to be junior secured creditors. (Presumably, but not necessarily, a creditor who had signed a subordination agreement could not use the Proposal against its senior.) And what if Chase itself procures a judicial lien? Can Chase, as a judicial lien creditor under the Proposal, take the first 20 percent and, as a perfected secured creditor, keep the next 80 percent?" White p.2.

losses by refusing to make further sales or advances or by requiring cash up front. Another common practice that protects unsecured creditors against oversecuritization involves the use of loan agreement covenants and ratios between the borrower and its unsecured lenders.

We agree with you that the Bankruptcy Code is a better place than the UCC for considering the Proposal. Bankruptcy lawyers would seem to have more expertise, and be better situated than the sponsors of the UCC—the ALI and the Commissioners on Uniform State Laws—to assess how the Proposal might affect credit practices, bankruptcy law, and tradeoffs between different classes of creditors. See Howard Ruda's May 22, 1996 letter to you [hereinafter "Ruda"]. To the extent that it seeks to aid certain classes of unsecured creditors (e.g., tort creditors and environmental lien holders), at the expense of traditional rules protecting secured creditors' collateral, the Proposal represents highly controversial social policy. Trying to enact this controversial Proposal in the context of the UCC is certain to lead to widespread opposition, and a lack of uniformity in the law.

3. Impact on the Credit Market. The impact of the Proposal seems likely to injure both secured creditors and debtors. If adopted, it would make secured lending more risky and expensive. This would restrict commercial credit especially for those borrowers who are most in need of it, including small businesses, start-up companies, and higher-risk companies. Moreover, as pointed out by Professor White:

> [T]he Proposal is likely to hasten bankruptcy for some debtors. Because sequential liens would greatly erode the claim of the senior secured creditor, that creditor would have to force the debtor into bankruptcy before any creditor (secured or not) with a large claim acquires a judicial lien....Whether and in what circumstances secured creditors will have enough power to force debtors into Chapter 11 and whether and in what circumstances they will be able to put them into bankruptcy involuntarily under §303 of the Bankruptcy Code is unclear. It is clear that the senior secured creditor would have a new—perhaps overpowering—reason to put the debtor into bankruptcy that the senior secured creditor does not now have.
> [White pp.5-6]

Other effects of the Proposal also might encourage more debtor bankruptcies, since unsecured creditors would have a stronger incentive to obtain judicial liens and foreclose on debtors' property, thus motivating more debtors to file for bankruptcy protection. None of these consequences are desirable for borrowers.

Theoretically, adoption of the Proposal might stimulate equipment leasing and other forms of investment (other than secured lending) that are not reached by the proposed changes to UCC 9-301. See White p.5; Ruda p.2. But modern equipment leasing often utilizes third-party purchase money financing, which would be undercut by the Proposal. Asset backed securitization practices also might be harmed. See Ruda pp.2-3. We are concerned that, in general, the 20% set aside Proposal may discourage the acquisition of capital goods and impede the free flow of commercial financing.

While the Proposal may be well intentioned, it could have a substantial negative impact on the availability of credit. Not surprisingly, representatives of small business have opposed the Proposal. Our conclusion is that this Proposal is ill-advised and contrary to the public interest.

Thank you for considering our views. ELA has a keen interest in these and other financial questions affecting the Nation.

We support the work of the American Law Institute, and we wish you and the ALI all success and good fortune.

Sincerely,

Michael J. Fleming, CAE
President

cc: Professor Charles W. Mooney, Jr.
Professor Steven L. Harris